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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 74-1630

TITAN GROUP, INC.,

Petitioner,

against

HAROLD FAGGEN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

	PAGE
Citations to Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes and Federal Rules Involved	3
Statement of the Case	4
Reasons for Granting the Writ	9
POINT I—There is a clear conflict between the decision herein and the rule of *Affiliated Ute Citizens* v. *U. S.* as consistently interpreted by the Circuits	10
POINT II—The refusal to apply compensatory damage principles herein exacts a penalty, in direct conflict with established law in other Circuits and the State Supreme Courts	21
Conclusion	28
APPENDIX A:	
Opinion of the Court of Appeals	1a
Judgment of the Court of Appeals	11a
APPENDIX B:	
Findings of Fact and Conclusions of Law, Tyler, U.S.D.J.	12a
Opinion of the District Court	36a
APPENDIX C:	
Statutes and Federal Rules Involved	41a
APPENDIX D:	
Excerpt From Petitioner's Brief on Appeal	42a

Table of Authorities Cited

Cases: PAGE

Affiliated Ute Citizens v. *U. S.*, 406 U.S. 89 (1972) 2, 4, 6, 7, 9, 10, 12, 14, 15, 16, 17, 18, 20, 21

A-Z Servicecenter Inc. v. *Segall*, 334 Mass. 672, 138 N.E.2d 266 (1956) 25

Blue Chips Stamps v. *Manor Drug Stores*, —— U.S. ——, 43 LW 4707 (1975) 18

Bowman & Bourdon, Inc. v. *Rohr*, 296 F.Supp. 847 (D. Mass. 1969), affd. p.c. 417 F.2d 780 (1st Cir. 1970) 19

Chasins v. *Smith, Barney & Co.*, 438 F. 2d 1167, 1172 (2d Cir., 1971) 15

Chris-Craft Industries, Inc. v. *Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973) 15, 17

City of New York v. *Brooklyn & Manhattan Ferry Co.*, 238 N.Y. 52 (1924) 26

Competitive Associates, Inc. v. *Laventhol, Krekstein, et al.*, Docket No. 74-2048, slip. op. —— F. 2d —— (May 8, 1975, 2d Cir.) 10, 11, 12, 14, 15

Davy v. *Crawford*, 147 F.2d 574 (D.C. Cir. 1945) 26

Green v. *Wolf Corp.*, 406 F.2d 291 (2d Cir., 1968) 27

Gruss v. *Curtis Publishing Co.* (S.D.N.Y., 1975), ¶ 95,036 CCH Fed.Sec.L.Rep. p. 97,625 .....24, 26

Hochfelder v. *Ernst & Ernst* 503 F.2d 1100, 1115 (7th Cir. 1974) 12, 13, 15

In re Greenberg, 46 F. Supp. 289, 291 (E. D. N. Y. 1942) 20

Metro-Goldwyn-Mayer v. *Ross, slip op.* —— F.2d —— (2d Cir., Jan. 13, 1975, Dkt. No. 73-2271) ..12, 13, 15, 16

Mill City Plastics, In Re, 129 F.Supp. 86 (D. Minn. 1955) 25

PAGE

Mills v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970) .. 15

Minn. Billiard Co. v. *Schwab*, 190 N.W. 836 (Wis., 1922) 27

Northtown Theatre Corp. v. *J. J. Mickelson*, 226 F.2d 212 (8th Cir. 1955) 25

Priebe & Sons v. *U.S.*, 332 U.S. 407 (1947) 26

Royal Air Properties, Inc. v. *Smith*, 312 F.2d 210 (9th Cir. 1962) 20

Seidlitz v. *Auerbach*, 230 N.Y. 167 (1920) 26

Shapiro v. *Merrill, Lynch etc.*, 495 F.2d 228 (2d Cir. 1974) 6, 15, 17

Supt. of Insurance v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1972) 16

Statutes and Rules:

Securities Exchange Act of 1934, Section 10b, 15 U.S.C. § 78j(b) 2

SEC Rule 10b-5, 17 C.F.R. 240.10b-5 .....2, 3, 4, 10, 14, 16, 17, 19, 20

New York U.C.C., Art. 8, sec. 102(a)(b) (62½ McKinney's Con. Laws) 23

Other Authorities:

Bromberg, Securities Law, § 2.6(2) 16
§ 7.4(2), p. 168.1 19

5 Corbin, Contracts, Sec. 1065 25

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit which affirmed the District Court's judgment dismissing petitioner Titan Group's demand for rescission or damages under four related acquisition contracts. The Court affirmed the award to respondent Harold Faggen of $5,500,000 plus accrued interest, on his counterclaim for recovery upon the face amount of installment notes issued to him as consideration for the questioned acquisition transaction.

Citations to Opinions Below

The opinion of the District Court on liability (Appendix ("App.") B) was stated from the bench and is not reported, and its opinion on damages (App. B) is also not reported. The opinion of the Court of Appeals (App.

A) has not yet been officially reported, but has been reported at ¶ 95,042 CCH Fed. Sec. L. Rep. [Current Binder].

Jurisdiction

The judgment of the Court of Appeals (App. A, 11a) was entered on April 1, 1975. Petitioner's application for rehearing and application for rehearing en banc was denied by two orders dated May 20, 1975. The time for filing this petition expires on June 30, 1975.

The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1) and Rule 19(1)(b) of the Supreme Court Rules.

Questions Presented

1. This is a question arising under the broad anti-fraud rules of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder—whether a case of material omissions to disclose requires separate proof of "reliance" upon the omitted facts, merely because the written selling material also involved affirmative misrepresentations of fact, where reliance had to be established for liability. The basis for the holding below raises the serious issue of what standard of law is to be applied in securities transactions where there are material omissions—should the Court have applied the "objective" test, of whether a reasonable investor might have deemed the omissions important? Or should it have used the "subjective" test it employed, of whether the particular investor herein, in its own mind, considered the omissions important, i.e. "relied" on the omissions? Petitioner Titan Group urges that under the ruling test of *Affiliated Ute Citizens* v. *U.S.*, 406 U.S. 128 (1972), the presence of omissions, without more and without separate proof of reliance, requires a finding of liability, if a

reasonable investor might have considered the omitted facts important, i.e., material, in the making of his decision. Application of such rule would have made respondent Faggen liable herein. Petitioner is urging that a mixed case of omissions and misrepresentations should receive no different analysis than a so-called "pure" omissions case, on the omissions branch of the scheme to defraud.

The scheme herein involved exaggeration of the earning power and business substance of an actuarial consulting business, whose stock was sold by respondent Faggen to petitioner Titan Group in exchange for securities.

2. Even if, *arguendo*, there is no Rule 10b-5 fraud claim, there is still a damage question herein—whether petitioner's promise to pay $5.5 million in ten year, subordinated, convertible notes maturing 1974-1978, and valued by the recipient at $3.2 million can be accelerated by him for payment seven years before maturity. They have been enforced at their full $5.5 million face amount, when the $2.3 million increment (the difference between face amount and actual value on acquisition date) represents a form of unearned interest or return on investment. In sum, can traditional principles of compensatory damages be disregarded in a securities case? Petitioner contends that the $2.3 million unearned interest component in the judgment is an unenforceable penalty upon acceleration, and should have been disallowed.

Statutes and Federal Rules Involved

The Securities Exchange Act of 1934, § 10b (15 U.S.C. § 78j(b)) and Rule 10b-5 thereunder (17 C.F.R. § 240.10b-5) are involved herein, and their text is set forth in App. C.

Statement of the Case

The facts relating to petitioner Titan Group's ("Titan's") acquisition of respondent Harold Faggen's ("Faggen's") actuarial consulting business are set forth in the opinion of the Second Circuit (App. A), but further relevant details are discussed *infra*. Titan contends there were material omissions and misrepresentations by Faggen in the memorandum he prepared for presentation to the Titan Board of Directors. The two key claimed omissions to disclose, as part of a scheme to overprice an acquisition, relate to (a) material loss of clients in the year preceding acquisition, and (b) adjusted earnings statements based upon undisclosed assumptions and improper accounting techniques.

With due respect, the decision by the Second Circuit herein has upset consistent interpretation of the law relating to omissions to disclose in Rule 10b-5 cases, by rejecting the objective "reasonable man" test of materiality, established in many cases, to substitute a subjective test of investment motives as applied by a trier of fact and affirmed on appeal as a "factual" determination. The attempt to distinguish and refusal to apply *Affiliated Ute Citizens* v. *U.S., supra,* has reversed several controlling precedents. As a result, Titan is being ordered to pay $5.5 million (plus interest) for a personal service business on the verge of liquidation for less than $150,000, primarily because of lost clients and non-existent earning power, all undisclosed before acquisition.

The ruling principle of Judge Waterman's Circuit Court decision is:

> "The case is not an appropriate one, in which to find materiality in the light of all the circumstances. This is a case both of alleged misrepresentations and of alleged material omissions. We view Judge Tyler's findings as determining that there was an abundance

> of evidence of the matters the plaintiff really considered important in entering this face to face transaction, that while the omissions might, in other circumstances, have been deemed material, the omissions were not material in these circumstances. These findings were not clearly erroneous, and correctly applied the applicable law" (App. A, 8a).

We submit that this is not applicable law—if an omission is material by the litmus test of the "reasonable investor", it remains material regardless of the circumstances. Materiality is not a rebuttable presumption; it is a rule of law. Its legal effect cannot be erased by a trier of fact superimposing a motivational investment test, and a psychological analysis of the underlying intent of the specific parties to a securities transaction. The touchstone is not a particular investor and his circumstances, but rather, the reasonable investor. Omissions which are material as a matter of law cannot become immaterial by reason of other motivational or psychological circumstances. As will be seen *infra,* the risk of prejudice by triers of fact (judge or jury) for or against particular litigants preclude a determination of materiality on any such basis as that suggested below. The amorphous concept upon which the *Titan* decision is founded can result in chaos, particularly to corporations faced with claims of "circumstantial" materiality, and deprives appellate courts of a clear legal standard for review of particular judgments in securities cases. In sum, the decision herein has ousted appellate tribunals from their hitherto tight control of the objective rule of law to be applied in securities fraud cases, and substituted an uncertain doctrine of "circumstances."

The omissions involved herein are, *inter alia*, the nondisclosure of a shrinking business—that 10% of the clientele of the Faggen consulting business had gone elsewhere in the year the acquisition closed. This loss of business with overhead remaining the same was bound to adversely affect

1969 earnings by as much as 20%. There was no disclosure that the biggest single client was lost in 1968, and that other key groups of clients were beginning to be lost before the acquisition closed, with reasonable probability of additional related clients being lost subsequently. Faggen supplied in his selling memorandum, prepared for presentation to Titan's negotiating officers and its board of directors, a written list of 143 clients, identifying 18 new ones between 1966-1968. In fact, 12 were already lost in 1966-68, 6 more were known to be in jeopardy and a disgruntled employee controlled 32 other clients—which he took with him right after the acquisition closed in December, 1968. A similar undisclosed alienation of clients had already occurred early in 1968. Undisputed evidence* showed a $386,922 shrinkage (40%) in the $1 million gross actuarial business of the Faggen Companies between 1966 and 1973. Most of this lost revenue and lost profit (because overhead did not go down) centered around $103,000 in annual billing (10%) lost by June 30, 1968, $90,000 more in jeopardy by October 1968 (9%), and the last $109,000 (11%) lost right after the transaction closed in December, 1968. These items which went to the heart of a personal service business were all undisclosed in an otherwise "bullish" written presentation listing new clients each year.

The foregoing was a *material* omission, because "All that is necessary is that the facts withheld be material in the sense that a reasonable investor *might have considered them important* in the making of this decision." *Affiliated Ute, etc. supra,* 406 U.S. at 153-154, quoted and applied in *Shapiro* v. *Merrill, Lynch, etc.,* 495 F.2d 228, 240 (2d Cir. 1974). But the Second Circuit decision herein has rejected this ruling test of materiality.

The second series of material omissions in this case relate to Faggen's presentation of adjusted earnings state-

* Trial Appendix ("App.") 1396-1398.

ments for four prior years in the selling memorandum, purporting to show what the Faggen Companies, which reported $350,000 in pre-tax earnings in 1968, would earn through elimination of certain expenses if they were part of Titan, a publicly owned company. The adjusted earnings for 1965-1968 portrayed more than $571,000 in pre-tax income for 1968, and nearly $500,000 annually for three preceding years to justify a ten times (pre-tax) earnings purchase price—$5.5 million face amount of notes maturing 1974-1978. But the assumptions undisclosed as to how such adjusted earnings were reached made them deceptive—E.g., a large amount of investment income (from stock market speculation) was plainly deducted from an earlier written presentation of adjusted operating earnings to Titan's negotiators, then put back into the four year income presentation, without disclosure, to inflate the earnings. Recurring expenses were treated as non-recurring by Faggen and excluded, also without disclosure. Negative adjustments were disregarded without disclosure, and salaries were assumed to have been cut which were then taken back, in other forms. Even at trial Faggen could not present in detail the adjustments he used to inflate earnings (claimed to have been run by him on adding machine tapes and thrown away) for any year of the four involved, except for 1968. And the 1968 adjustments proved to have been watered in large part—He went from $350,000 in reported taxable income to $571,000 in adjusted 1968 income. But of the $221,000 in unexplained adjustments, $163,000 proved to be the result of invalid or questionable accounting assumptions, whose application was neither disclosed nor explained. The Court below also refused to measure these omissions by the "reasonable man" test of *Affiliated Ute, supra.*

Titan supplied a body of accounting principles of disclosure with which Faggen failed to comply in restating "Net Income" for the years 1965-68 in his memorandum to Titan. The disclosure principles violated were so funda-

mental that there was no reasonable answer to them. But the Circuit Court opinion dismisses them in a footnote, holding "The income statement is clearly only a presentation of rough bottom line figures and not a financial report to which accounting principles and rules apply." (App. A. 4a). But Faggen's income statement is far from rough, supplying dollar figures in precise detail, as follows (Trial App. 1371):

"Net Income—Pre-Tax
Adjusted to basis which will
prevail after acquisition

	Fiscal Years Ending In:			
	1965	*1966*	*1967*	*1968*
Harold Faggen Associates, Inc. (June 30)	$253,357	$367,087	$332,192	$430,596
Actuarial Tabulating Corp. (March 31)	59,878	60,976	59,201	65,806
Employee Fund Services Corp. (Sept. 30)	32,767	27,891	25,252	29,104
Fund S & E Corp. (June 30)	—	—	—	10,476
Harold Faggen, Personal (Dec. 31)	34,800	34,800	35,240	35,280
Total	$380,802	$490,754	$451,885	$571,262"

The statement is even broken down for each of Faggen's corporations, by their date of fiscal closing, and gives exact figures on his personal accounting practice included in the total each year. Moreover, only "bottom line" income figures were given because the "top line" revenue and expense figures were separately supplied in precise detail by certified public accountant Faggen in his four years of tax returns separately given to Titan. His exact sales figures (cash basis receipts) that led to these bottom line income figures were well known and discussed by the Titan Board (Trial App. 1344, 975, 1382, 390-391). The opinion ignores this background to the selling memorandum which made it a financial report subject to disclosure requirements, particularly as to invalid and questionable accounting assumptions

used to reach the earnings shown. Titan contended that a seller of securities cannot evade his duty to disclose his hidden accounting assumptions merely by dividing up his numerical presentation into three sets of papers—1) tax returns, 2) adjustments in detail for 1968 and 3) adjusted income totals for 1965-1968. The testimony was undisputed that Titan's negotiating officers read them together, and priced the $5.5 million transaction based on over $500,000 in pre-tax earning power, which did not in fact exist.

The decision herein rejects the omissions to disclose a shrinking business, and rejects the omissions to disclose how an exaggerated portrayal of four years past earning power was prepared, as beside the point, saying "After a bench trial, Judge Tyler rejected the claims of Titan, and found that Titan had not relied in any way on Faggen's representations. . . . Tending to buttress the absence of any determinative reliance upon Faggen's representations the judge pointed out such factors as the relative position of the parties, their arms-length negotiation, and Titan's long opportunity to examine the financial status of the Faggen Companies prior to closing the deal . . . we conclude that Judge Tyler's findings are amply supported by the record and are not clearly erroneous findings" (App. A., 6a). In sum, two fundamental series of material omissions under the *Ute* test were disregarded, because a trier of fact held that a particular securities buyer did not *rely* on the earning power of a business in deciding to invest $5.5 million therein, but had other subjective investment motivations. The objective test for the materiality of such omissions on a "reasonable" investor was neither disputed nor analyzed—it is in effect conceded.

Reasons for Granting the Writ

Certiorari should be granted herein because the Second Circuit, while paying nominal recognition to the rule of *Affiliated Ute Citizens* v. *U. S.*, *supra*, in the *Titan* decision, has in fact refused to apply it. It has further refused to

apply long standing compensatory damage principles prohibiting the exaction of a penalty when notes are accelerated, which is a separate ground for certiorari herein.

POINT I

There is a clear conflict between the decision herein and the rule of *Affiliated Ute Citizens* v. *U. S.* as consistently interpreted by the Circuits.

Titan v. *Faggen* is an anomaly under Rule 10b-5, upsetting the logic in several major cases applying the rule of *Affiliated Ute Citizens* v. *U. S., supra.* For example, see *Competitive Associates, Inc.* v. *Laventhol, Krekstein, et al.*, Docket No. 74-2048, slip. op. —— F. 2d —— (May 8, 1975, 2d Cir.), which holds, as Titan contends, that in a mixed question of misrepresentations and non-disclosures, the plaintiff need not prove reliance upon the non-disclosures. The substance of Titan's case was that Faggen exaggerated the earning power and potential performance of his companies by two categories of material omissions, in a presentation that also contained misrepresentations. Plaintiffs in *Competitive Associates* and in *Titan* both claimed the material omissions, combined with misrepresentations, were part of an overall scheme to defraud which violated all of the provisions of Rule 10b-5. In both *Competitive Associates* and the *Titan* case, the Rule 10b-5 transactions complained of involved face-to-face discussions of a corporate acquisition transaction, an accounting investigation by the plaintiff before closing, no activity in the public marketplace, and private transactions not involving any public class of security purchasers. Judge Hays in *Competitive Associates* applied *Affiliated Ute* as follows:

> "As a matter of law, the district court erred in its determination that plaintiff could not prevail unless it could prove direct reliance on the false financial statements certified by defendants. The Supreme

> Court specifically rejected such a restrictive reading of section 10(b) and Rule 10b-5 in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972).
>
> • • •
>
> "This Court has also expressed the view that a plaintiff need not prove that non-disclosure of material facts induced its purchases, but need only allege that it would not have acted as it did had it known of the information withheld by defendants. . . .
>
> "Defendants, relying on a distinction set forth in dicta in *Schlick* v. *Penn-Dixie Cement Corp.*, CCH [Current Decisions] Fed. Sec. L. Rep. ¶ 94,853 (2d Cir. 1974), submit that the instant case involves allegations of misrepresentation as opposed to non-disclosure and that therefore plaintiff must show reliance in addition to causation in fact. However, as this court made quite clear in the *Schlick* case in which the district court's dismissal of plaintiff's complaint was reversed, a showing of reliance is not required where a comprehensive scheme to defraud which includes not only omissions and misrepresentation, but substantial collateral conduct as well, is alleged. ¶ 94,853 at 96,876. Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws. In the case before us, plaintiff has charged the accounting defendants not only with affirmative misrepresentations in the financial statements, but also with a failure to disclose the true financial condition of Takara Partners and the alleged receipt of payoffs in return for its certification; furthermore, both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud. Under these circumstances, plaintiff need only show causa-

tion in fact; in order to do so plaintiff should have the opportunity to prove, *but is not required to prove,* that it saw, or directly relied upon, the financial statements certified by the accounting defendants. Cf. *Hochfelder* v. *Ernst & Ernst,* 503 F.2d 1100, 1115 (7th Cir. 1974)." (Slip op. 3479/80/81) (Emphasis ours.)

Besides the quoted Seventh and Second Circuit expositions of *Affiliated Ute, supra,* see *Metro-Goldwyn-Mayer* v. *Ross,* slip op. —— F.2d —— (2d Cir., Jan. 13, 1975, Dkt. No. 73-2271). On a legally identical omission, that decision also reached exactly the opposite result from *Titan* v. *Faggen* and properly applied the *Affiliated Ute* principle of legal causation in a corporate acquisition where the business was made to appear better than it was. First, the M-G-M accountants (Arthur Anderson & Co.) made a detailed "purchase investigation" over several months, much more thorough than Titan made of Faggen. In M-G-M, their accountants came up with revised net worth figures before the closing far below those represented by the acquiree, finding overstatements which were a clear warning of others. Yet, notwithstanding this investigation, the seller was still held liable in M-G-M for omitting to disclose that which a more thorough investigation would have turned up:

"[There were] representations made by Ross employees that the Ross companies followed the common practice of providing to distributors three so-called free records for every 10 single records purchased and two free records for every 10 albums . . . In its claim for rescission, M-G-M relies primarily on the failure of the Ross brothers to inform it of some 70,000 records which the Ross companies had given to distributors free of charge, over and above the usual three on 10 and two on 10 arrangements, which M-G-M had been told was in force . . .

"The district court's conclusion that there had been no violation of a duty to disclose was based in large part on

the fact that during the purchase investigation the Ross companies provided Arthur Andersen with inventory cards which, if explained and interpreted properly, could have revealed all but 12,500 of the 70,000 additional records. However, Rule 10b-5, as well as the terms of the exchange agreement, required the Ross brothers to state all material facts necessary to make other statements not misleading . . . Such a duty is not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can. . . .

"In concluding that the Ross brothers had satisfied their duty to disclose, the district court also relied on evidence that . . . M-G-M Records knew that some additional records were being distributed free of charge by the Ross brothers and that M-G-M and industry practice was to distribute some no-charge records beyond the three on 10, two on 10 standard. However, in light of the statements by Ross employees that free records were distributed on a three on 10, two on 10 basis, M-G-M was entitled to a full disclosure that large numbers of additional records were being distributed free of charge."

Faggen's presentation of a "bullish" list of 143 clients is legally identical to the Ross Bros. disclosure of its free record policy. So is Faggen's omitting to disclose the shrinking clients, just as the Ross Bros. omitted to disclose their additional free records. Both omissions involved a material reduction in future revenues and profits. Circumstances of M-G-M knowing "some additional records were being distributed free" and M-G-M's own policy and industry practice, were all held irrelevant, as were circumstances of an intensive accounting investigation before the closing. *Metro-Goldwyn-Mayer* v. *Ross, supra,* is controlling precedent, neither followed nor distinguished in the *Titan* decision, and with *Competitive Associates, supra* and *Hochfelder* v. *Ernst & Ernst, supra,* represents a split within as well as among the Circuits.

1. *Reasons for the Affiliated Ute Rule.* An unsound analysis underlies the decision herein holding, in effect, that in a mixed case of misrepresentations and omissions, reliance on both the false statements and separate reliance on the deceptive omissions must each be factually proven. Petitioner believes that this is not the law, with all due deference. There is no basis in precedent or practical common sense to have one rule of law for pure omissions, and another for omissions diluted by misstatements. The *Affiliated Ute* principle of constructive reliance inferred from a genuinely *material* omission has to apply in all cases under 10b-5(2), and in all fraud claims under subparagraphs (1) or (3) of such Rule, where failure to disclose is an important element in the deception. Fraud cases do not fall into neat categories, as observed in *Competitive Associates, Inc.* v. *Laventhol, etc., supra.* If the plaintiff presses only affirmative misstatements, he must show reliance in fact.[1] But if plaintiff presses an omission too (and it only takes a single substantial omission to prevail under Rule 10b-5), then the principle of causation implied from materiality applies to the omission branch of his case. How can the court give buyers the impossible burden of proving "reliance" on that which they never knew?

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[1] There was, however, ample proof of reliance in the Court below, see testimony in Titan's Brief on Appeal 48-52, reproduced in App. D, 42a. Six out of the seven directors who voted for the acquisition definitely recalled the exaggerated earnings as the basis for their approval of the transactions, and none of them were told of the questionable accounting assumptions used to reach such results, or of the lost clientele. It further defies psychological reality, regardless of additional acquisition motives, to hold that the buyer of a business with only $1.6 million net worth was willing to pay $5.5 million and did not care what its earnings were, and would not care if they were dwindling.

The ruling cases going back to *Chasins* v. *Smith, Barney & Co.*, 438 F. 2d 1167, 1172 (2d Cir., 1970) and *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970), which are precursors of *Affiliated Ute*, all base "constructive reliance" on the impossibility of proving reliance in an omission situation. The erroneous principle used in the *Titan* case by the District Judge, then confirmed as a factual finding by the Circuit, further makes it advantageous to provide a great deal of false data in selling material to blur the impact of a single important omission—such as a shrinking business. *M-G-M* v. *Ross, supra,* is a typical example of a mixed question of misrepresentations (over-stated receivables) and material omission (undisclosed free records policy), where the omission alone, and its materiality, were all that were required in a face-to-face acquisition transaction. So are *Competitive Associates, etc.* and *Hochfelder* v. *Ernst & Ernst, supra.* Moreover, the face-to-face distinction suggested in the Circuit's decision herein (8a) is irrelevant, because *Affiliated Ute* was a face-to-face fraud and is so described in *Shapiro* v. *Merrill, Lynch, etc.,* 495 F. 2d at 240; the constructive reliance doctrine originates in face-to-face omissions, and "that rule is dependent not upon the character of the transaction—face-to-face versus national securities exchange—but rather upon whether the defendant is obligated to disclose the inside information". Similarly *Chris-Craft Industries* v. *Piper Aircraft Corp.*, 480 F. 2d 341, 376-377 (2d Cir. 1973), applying the *Ute* test correctly, also involved both misstatements and omissions to disclose.

2. *Dangers in Allowing the Titan Decision to Stand Uncorrected.* The decision herein accepts the ruling cases, but then contradicts them by an invalid distinction. *Affiliated Ute* is erroneously characterized as an instance of "total non-disclosure," (8a) when it too was a mixed package. See 406 U.S. at 152, "the record reveals a misstatement of a material fact, within the proscription of Rule 10b-5(2), namely, that the prevailing market price

of the UDC shares were the figure at which their purchases were made." *Bromberg, Securities Law,* ¶ 2.6(2) further points out (cited in *Ute* at 154), "Clause 2 [of Rule 10b-5, false statements and omissions], by its own terms, operates only if some statement is made, and this outlaws half-truths and other forms of partial silence or failure to disclose." An omission to state a material fact necessary to make other statements not misleading always requires other statements to have been made. Faggen's list of clients is just such statement that became deceptive because of his omission to disclose lost clients. So too was the omission in *M-G-M, supra,* superimposed on a statement of a normal, and therefore "bullish," free record policy. There is probably no such animal as an instance of "total non-disclosure" in an acquisition transaction. The *Titan* decision erroneously suggests a special rule for acquisition transactions in securities, when by its terms Rule 10b-5(2) and the other provisions of Rule 10b-5 prohibit *all* forms of fraudulent schemes. *Supt. of Insurance* v. *Bankers Life and Casualty Co.,* 404 U.S. 6 (1971). No acquiree can sell his business for several million dollars without saying something, and once he begins to speak, he must speak fully and fairly on all matters important to a reasonable investor. The test in acquisitions must be the same as in open-market transactions, for the same all-embracing Rule 10b-5 covers both.

The holding herein is that a weighing by the trier of fact of what "the plaintiff really considered important" (8a) should control, even though there has been a substantial omission. But by definition, an omission means plaintiff did not have the opportunity to weigh it in his investment analysis; so how can the trier of fact weigh it for him? An omission cannot be material in some circumstances, but immaterial because plaintiff's attention was directed at other factors. It is just this diverting of a buyer's attention away from a material adverse business item that he "might have considered important" (the *Ute* test),

that makes it impossible to use what he *does know,* to dissipate the conceded importance of what he *does not know.* Once an omission is found to be material by the objective tort law test of the "reasonable investor," all his presumed other motivations are under a cloud of deception. The investors in *Ute* are not the first instance of an investment decision where certain factors are weighed, but a key issue is missed entirely. The theory of an objective test is that full knowledge might change one's mind, and the investor should have the right to make that decision himself.

Constructive reliance is not a mere procedural tool to allow proof more easily, but reflects a substantive determination of how people are "taken" in securities transactions, by what they do not know. If a reasonable man might attach importance to the fact omitted, it is material and it remains material. Materiality is not a transitory concept, akin to a rebuttable presumption; it is the substantive foundation of any case under Rule 10b-5. *Affiliated Ute* has "established a rule of law rather than a presumption," Mansfield, J. concurrence in *Chris-Craft Industries, supra,* 480 F. 2d at 400.

Analysis ends with the litmus test in *Ute* and *Shapiro,* not subject to the visceral attitude of a trier of fact as to what "really" mattered in a stock market-business context five years before. Because the District Court used a wrong test, it reached a wrong result—and now the Circuit Court has uplifted this "factual" finding into an erroneous rule of law. The danger of ousting the appellate tribunals from correct legal review of the huge amounts involved in securities cases is apparent, when a trier of fact disregards an objective materiality test in favor of a psychological-motivational test of investor intent. The only path open on appellate review is then whether the factual findings of court or jury were "clearly erroneous." Meaningful judicial review in these large cases, often class actions, thus becomes effectively impossible.

In these types of transactions, it is hard facts, stated and unstated, that must control, not judicial reconstruction of acquisition attitudes in 1968. That is a function of Wall Street historians, and District Judge Tyler's rarefied hypothesis notwithstanding, there were some "reasonable" acquirers in 1968 who cared about earnings. Will the next Circuit applying *Titan* hold that circumstances can make an omission material which was *not* material under the objective test? The converse of the erroneous rule herein is as dangerous as its instant application, and the *Titan* holding is an uncertain sword that can do harm in many directions. The attempt in the Circuit Court to reconcile the District Court's blatant disregard of *Ute* erects an impossible doctrine—that *Ute* applies only to "pure" omissions cases, and that mixed questions of false statements and omissions can never come under *Ute,* when nearly all cases, whether private or open-market securities transactions, are such mixed questions. The *Titan* holding supplants objective materiality with "circumstances," i.e., acquisition intuitions by triers of fact. A sound rule of law should avoid debatable questions of motivation in this field.

Taking only its application herein, how can an appellate panel apply a "clearly erroneous" standard of review, to a determination by a trial judge of why a buyer "really" bought a company, which necessarily determined *nothing* could change the buyer's mind? A District Judge has held that no matter what Faggen might have said about lost clients or illusory earnings adjustments, it could not have changed Titan's decision to invest. Can such a far reaching determination ever be reviewable, much less be logical? Counsel should not be in the position of attacking a trier of facts' intuition, by raising his prejudicial opinions of small conglomerates, circa 1968, and their particular negotiating agents, respectfully believed to have been at the heart of the District Court's findings herein. As recently as *Blue Chip Stamps* v. *Manor Drug Stores,* 43 LW 4707 (1975), the

Supreme Court has indicated a strong public policy in favor of objective tests of liability in securities cases. An action under Rule 10b-5 should not "turn largely on which oral version of a series of occurrences the jury may decide to credit," and should not "throw open to the trier of fact many rather hazy issues of historical fact . . . [dependent] on oral testimony . . .," (43 LW at 4713) and (Powell J., concurring), "We do not believe that such a shifting and highly fact-oriented disposition . . . is a satisfactory basis for a rule of liability imposed on the conduct of business transactions" (4717). An objective, non-intuitive test of materiality is absolutely required in both pure and mixed omissions cases for the guidance of juries, judges and the bar. Those who seek to comply with Rule 10b-5 have to know, in advance by a clear legal test, what is material and what is not material. Such matters cannot be left to a subsequent reconstruction of "circumstances" or motives. Certiorari should be granted to reverse an erroneous concept embraced by a panel in the leading circuit in financial-securities litigation.

3. *A Concept of Financial Statements That Is Too Narrow.* The Circuit Court also excludes all disclosure accounting principles from this case, by holding that Faggen's four year income presentation was not a financial statement and relevant explanations could therefore be omitted. What then may be deemed to be a financial statement or a financial representation requiring full disclosure, for purposes of Rule 10b-5? *Bromberg, supra,* ¶ 7.4(2), p. 168.1, treats bottom line earnings information as a material disclosure item, without any supporting numerical data—sales, expenses, etc. "Earnings information becomes more material with the length of the period it covers [herein, it covered 4 years], and with the variation in result from the prior corresponding period." See *Bowman & Bourdon, Inc.* v. *Rohr,* 296 F. Supp. 847, 849, 851 (D. Mass. 1969), affd. p.c. 417 F. 2d 780 (1st Cir. 1970), where the defendant's inventory report *alone,* without explanation of certain questionable

assumptions, resulted in liability. The unexplained inventory count and pricing were deceptive as they went into the accountant's financial report. In *Royal Air Properties* v. *Smith,* 312 F. 2d 210, 212 (9th Cir. 1962), the deceptive financial presentation in a face-to-face transaction was a "Land Use Analysis-Proposed Development Plan", with "estimates of profits and of return to investor", omitting to describe the cost of the land or mortgage requirements. Financial representations much less detailed than Faggen's have been the basis for liability in the cited 1st and 9th Circuit cases, and the decision herein ignores these clear precedents in other Circuits.

In re Greenberg, 46 F. Supp. 289, 291 (E. D. N. Y. 1942), held that a mere *letter* to a bank stating that a bankrupt was building an apartment house, had a tentative mortgage commitment, and owed less then $1,000, was a financial statement. "Those were the documents on which he desired the bank to rely and they were his representations of his financial condition, and viewed from any standpoint, constitute a financial statement for the purposes he had in mind." A similar functional definition of financial statement should be applied to Faggen's earnings presentation (p. 8, *supra*).

Moreover, disclosure obligations apply to any factual statement, whether called a financial statement or not. Since when can even "rough" figures be deceptive in substantial amounts, through lack of explanation? The omitted financial disclosures thus fall under *Affiliated Ute, supra.*

Certiorari is justified here to avoid the mischief which will result throughout the Circuits by others invoking the erroneous principle of *Titan* v. *Faggen,* that omissions can be material as a matter of law, but become immaterial because of other circumstances to be determined by a trier of fact. A single objective test of materiality must be enforced whenever there is an omission scheme in any Rule 10b-5 case. The "surrounding circumstances" must be examined only to determine whether a *reasonable* in-

vestor, not the individual investor, would attach importance to the omission. Otherwise *Ute* and its progeny will soon be undone by findings of fact that go afield of the objective legal test that must control.

POINT II

The refusal to apply compensatory damage principles herein exacts a penalty, in direct conflict with established law in other Circuits and the State Supreme Courts.

A $5.5 million judgment (plus interest since 1972) in this case was excessive. It was not based upon traditional compensatory damages for breach of contract—it contained "penalty" damages. The District Court dismissed Titan's claim, and granted judgment on the counterclaim accelerating payment on the notes. But the judgment for the face amount (which included *unearned* interest and return on investment) of these low-grade notes seven years before principal matured amounted to a penalty. Faggen, himself recognizing the commercial reality of the situation, urged that Titan's 4% convertible subordinated installment notes due in ten years (the "Notes") were not worth their face amount of $5.5 million on December 2, 1968 when received—but were worth "at most" only $3.2 million on issuance in December, 1968. These 10-year corporate securities, paying only 4% per annum (when high grade debt was yielding 12% in 1974), subordinated to senior debt owed to banks and other lenders, could not grow into $5.5 million in just three years without, in effect, enforcing a concealed interest penalty against Titan of $2.3 million. The District Court, as affirmed, ruled on a single ground; "it cannot be said, however, that at the time of sale, Faggen's business was not in fact worth $5,500,000 to Titan. Given this fact, it would not be proper for this Court to say that the $5,500,000 in notes received by Faggen represented a concealed

interest rate of $2,300,000" (App. B. 40a). This amorphous valuation ruling is not a mere "straw man," for it was not disturbed on appeal.

What basis was there for saying a seller willing to take only $3.2 million was really selling a commodity worth $5.5 million cash? Can a trier of fact assume that what is worth $3.2 million to a seller is in fact worth $5.5 million to a buyer?—particularly after concluding seller's earnings "didn't prove out to the dollar" (App. B. 34a). There is not a shred of evidence to support this legal conclusion giving a $2.3 million damage windfall. Overall net worth was $1.6 million, and the excess net worth in the Faggen Companies not used in operations was $1 to $1.3 million. Did that make the cash alone worth five times that, $5.5 million, in the prosperous year 1968 when borrowed money was relatively easy to come by for corporations? Commercial common sense does not support such reasoning, and the best test of value is what a seller said he wanted for his pool of assets—subordinated, convertible securities of Titan with a value of $3.2 million in cash equivalent. The zone between what a seller received and what a buyer obtained for his money cannot be assumed to be a gulf over $2 million wide.

1. *Nature of the Securities.* Titan gave a block of relatively "low grade" corporate securities as the form of payment under its contracts with Harold Faggen. The Notes, as between Titan and Faggen, did not have a life of their own and were merely an executory promise of future performance of the over-all contract at a low interest rate, in a subordinated form, with ten years ahead for their pay-out, and with an equity feature whose potential for capital gain from a market rise in Titan stock was in 1968 their principal attractiveness to Faggen. Faggen was not a bona fide purchaser or holder in due course of a convertible note bought in the bond markets—he was merely the owner of a bargained-for installment covenant, with a conversion right, subject to all the prior

dealings and equities that gave rise to the obligations. The securities received by Faggen in this transaction were a substitute for his demand for 500,000 shares of Titan common stock in the initial negotiations and were much closer to an equity security in their fundamental nature and in the minds of both parties, than they were a debt security.[1] Calling a promise to pay a "note" and putting it in an exhibit to the contract on separate pages does not make it one, as between the original parties. Even under the New York U.C.C., Art. 8, sec. 102(a)(b) (62½ McKinney's Con. Laws), these "Notes" were investment securities, not commercial paper, and they were unregistered under the Securities Act of 1933 and not readily marketable.

It is clear that Faggen did not loan $5.5 million in cash to Titan; he traded the $1.6 million in net assets of his business for specialized securities. In evaluating his rights (different from a bona fide open market purchaser) under these Subordinated Convertible Notes, the normal protective provisions between true creditors and true debtors, such as the acceleration provision herein, must be tempered by the financial realities of the instant bargain. This was not normal indebtedness for borrowed money; it was qualified indebtedness for bartered assets.

The essence of these Notes is that $3.2 million in 1968 present value became $5.5 million in 1978 future value by capitalizing a fair return on investment each year for ten years, and adding $2.3 million into principal payable in the future. As Faggen's own expert Frederick Shinagel testified, through his memo in evidence of March 5, 1974 (Trial

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[1] The fact that no principal was to be paid until 1974 gave it the "tax deferred" quality (similar to a tax-free stock-for-stock reorganization) Faggen desired until cash payments in bulk were received, and the 4% interest was the minimal return necessary to avoid a higher imputed interest rate under the Internal Revenue Code; the true return on investment was added into principal to insure capital gains.

App. 1729-1730):

> "If, for example, the 4% interest rate of the Notes were the appropriate one, then the present value of the Notes would be equal to their future or face value. That would mean the interest payments from the Notes fully compensate for the cost of money, inflation, risk, marketability, etc. Such is not the case . . . Considering . . . the substantially leveraged capital structure with 75% debt, the absence of collateral security for the Notes and their subordination to any future institutional or bank debt that may be created, it would appear that an interest rate of 11% would be appropriate here. Since the Notes already pay 4% interest, the present value derivation should be calculated using a rate of 7% (i.e., 11% minus 4%) . . . =$3,215,000. . . . Overall, value on December 2, 1968 was, at most, $3,200,000."

But time had to pass for this built-in return on investment at 7% per annum to accrue and grow to $5.5 million by 1978.* To pay the extra $2.3 million of principal as of 1972, seven years before the term of the Notes has elapsed, is to pay unearned interest which has been capitalized to reach $5.5 million. This amounts to a penalty for default rather than fair compensation for breach of contract. $5.5 million plus interest as of 1972 is, in effect, giving Faggen $8-10 million as of 1978 when he would otherwise have been paid. His ability to re-invest the prepaid principal creates a windfall substantially beyond the value of the promised performance.

2. *Ruling National Cases Disregarded.* Certiorari is justified herein because the Circuits and State Supreme Courts have a uniform rule on this point, disregarded in

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* Shinagel was recently an expert witness in a parallel valuation case where appraisal value of preferred stock promised to be redeemed at a set future date, was subjected to a present value discount analysis. *Gruss* v. *Curtis Publishing Co.* (S.D.N.Y., 1975), ¶ 95,036 CCH Fed.Sec.L.Rep. p. 97,625.

the instant case. An acceleration clause in notes was declared an unenforceable penalty in these circumstances in *Northtown Theatre Corp.* v. *J. J. Mickelson,* 226 F. 2d 212, 214 (8th Cir. 1955), because "the acceleration clauses in the circumstances disclosed by the record created a penalty and hence were unenforceable and that having invoked the acceleration clause as the basis for its claim to unearned interest it was not entitled to recover."

With precise application to Faggen's position the same case below, *In Re Mill City Plastics,* 129 F. Supp. 86, 90 (D. Minn. 1955), says: "if petitioner were allowed the full amount of its claim it could reinvest and be substantially better off than if the bankrupt had fulfilled its contract according to its terms." The District Court herein itself accepted this principle that capitalized interest cannot be awarded before it is earned, saying an acceleration clause should be unenforceable when it would result in the payment of unearned interest, citing *A-Z Servicenter, Inc.* v. *Segall,* 334 Mass. 672, 138 N.E.2d 266 (1956) and 5 Corbin, *Contracts,* Sec. 1065. We submit that a $2.3 premium for holding convertible notes for their ten year term is equivalent to capitalizing unearned interest—it is a fair return on investment built into the face amount of the Notes whether it is called unearned interest or principal amount. These Notes (really convertible debentures) were first sold to Faggen at 60 ($3.2 million value is 60% of $5.5 million face and is a fair test of value of the assets conveyed as well) and had to be held 10 years to repay par value of 100. Faggen's return on investment was not intended to be paid on "breach date" May 1, 1972, a mere three and a half years after the deal started. The result here gives him a windfall to reinvest at high interest rates, and by maturity date of the first $5.5 million, he will have $8-10 million cash on hand—damages for breach of contract have yielded him more than performance ever would.

Faggen even preserved his options on the conversion rights. If they had any value, he would not have ac-

celerated in 1972 and merely held for seven more years or converted and sold the underlying stock at a speculative profit. Faggen lost none of his options and profited solely from a lawsuit.

Any provision of a contract—whether it is called a liquidated damages provision explicitly or whether it is an acceleration provision which results in additional damages, must be evaluated realistically to determine if it operates as a penalty. *Davy* v. *Crawford,* 147 F. 2d 574 (D.C. Cir. 1945). See *Priebe & Sons* v. *U.S.,* 332 U.S. 407, 413, 418 (1947), "The essence of the law's remedy for breach of contract is that he who has suffered from a breach should be duly compensated for the loss incurred by nonperformance. But one man's default should not lead to another man's unjust enrichment." See *Seidlitz* v. *Auerbach,* 230 N.Y. 167, 174 (1920, Andrews, J.) "The parties must not lose sight of the principle of compensation," or *City of New York* v. *Brooklyn & Manhattan Ferry Co.,* 238 N.Y. 52 (1924), "The tendency of the courts in doubtful cases is to favor the construction which makes the sum payable for breach of contract a penalty rather than liquidated damages."

The discounted value analysis of *Gruss* v. *Curtis Pub. Co., supra,* is as relevant to the present value of the subordinated convertible notes herein as it was therein to preferred stock—promised for redemption in 1986, "leading to a discounted present value at the end of 1972. . . . This computed figure must be reduced substantially to allow for a [further] foreseeable contingency . . ." (*Gruss, supra.*) There is little substantive difference between a promised redemption of preferred stock or a promised redemption of subordinated convertible notes. A decent respect for the rights of all participants in a public corporation—senior creditors and shareholders—mandates a present value analysis herein, particularly with the strong public policy against assessing any penalty damages against

corporations. See *Green* v. *Wolf Corp.,* 406 F.2d 291, 303 (2d Cir., 1968). Turning a seven year $5.5 million subordinated debt into a current senior liability, with its attendant diminution of future credit, and jeopardy of existing credit relationships, is not a punishment to be lightly imposed. This acceleration clause as held in parallel cases, has exacted "a penalty with a vengeance." *Minn. Billiard Co.* v. *Schwab,* 190 N.W. 836, 838 (Wis., 1922). The national authorities cited include the Eighth and D.C. Circuits, and the highest Courts of New York, Massachusetts and Wisconsin, *inter alia.*

On the issue of whether acceleration effects a penalty herein, a single fact looms as controlling—principal had still not come due even when the appeal was argued; the first installment was due November 1, 1974 and they run through 1978. The effect of the judgment is to enhance Faggen's position by $2.3 million in windfall profit from early payment on high-risk unmarketable debt securities. It is grossly inequitable to call a refusal to pay a $110,000 interest payment a "default," when a fraud case is concurrently pressed in Federal Court, and then allow the "default" to give rise to enforcement of an acceleration clause yielding such a huge windfall, i.e., a return on investment without staying at risk in the investment. Senior creditors who loaned real money to the corporation, and thousands of public shareholders should not be so disadvantaged.

Certiorari should be granted to enforce these universally accepted principles limiting recovery upon acceleration to compensation damages.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Dated: June 20, 1975.

Respectfully submitted,

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APPENDIX A

Opinion of the Court of Appeals.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 239—September Term, 1974.

(Argued October 25, 1974 Decided April 1, 1975.)

Docket No. 74-1694

TITAN GROUP, INC.,
Plaintiff-Appellant,

v.

HAROLD FAGGEN,
Defendant-Appellee.

Before:

WATERMAN, OAKES and GURFEIN,
Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, Tyler, *Judge,* dismissing appellant Titan Group's demand for rescission of four contracts and awarding appellee Harold Faggen $5,500,000 plus accrued interest on his counterclaim for recovery upon promissory notes.

Affirmed.

LAWRENCE M. POWERS, STEVEN E. GROSS, MARTIN M. GREEN, POWERS AND GROSS, New York City, *for Plaintiff-Appellant.*

BURTON S. COOPER, EDWARD LABATON, JOHN C. FEFFER, SHEIB, SHATZKIN & COOPER, New York City, *for Defendant-Appellee.*

WATERMAN, *Circuit Judge:*

Titan Group, Inc. (Titan) commenced its action in the United States District Court for the Southern District of New York against Harold Faggen seeking the rescission of four contracts Titan had entered into with Faggen. Titan alleges that the defendant had violated Section 10 (b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (b) (1970) and Rule 10b-5 promulgated under the 1934 Act, 17 C.F.R. § 240.10b-5 (1973), by making false and misleading statements and by failing to disclose material facts in connection with negotiations leading to Titan's acquisition of four actuarial companies owned by Faggen. Faggen counterclaimed for the principal and interest on promissory notes which he had received in payment for his companies. After a bench trial, Judge Tyler dismissed Titan's claim for contract rescission and awarded Faggen $5,500,000 plus interest on his counterclaim. Titan appeals from the dismissal of its complaint and from the award to Faggen on Faggen's counterclaim.

We affirm the results reached below.

At the heart of this appeal lies the question of the appropriate legal significance to be accorded two memoranda Faggen prepared which were presented to Titan in the discussions prior to the drafting and execution of the contracts. Therefore it is necessary to recount in some detail the facts before the trial judge.

In 1968, Faggen began to consider selling his actuarial companies and he engaged in tentative discussions with several potential purchasers of them. Titan was a conglomerate with a concentration in real estate and construction.

At this time Titan, under new management control, was seeking to diversify, and, additionally, it wanted to enhance its cash position. A New York lawyer, Benjamin Robinson, who had close professional ties with Faggen, was Chairman of Titan's Board of Directors.[1] Aware of perhaps complementary interests, Robinson introduced Faggen to Anthony Frank, the president-director of Titan. When serious negotiations began another attorney, Edmund Kaufman, an attorney with considerable experience in corporate acquisitions, was brought in as Titan's special counsel.

Kaufman and Faggen met for the first time on September 6, 1968. Faggen presented Kaufman a copy of the tax returns of his largest company for the last fiscal year and, also, a memorandum of adjustments to earnings. These adjustments added to the income reported on these tax returns the income of Faggen's three smaller companies, and noted certain possible economies relative to pension funding, liability for city and state taxes and payments for salaries, and also noted the existence of certain non-recurring expenses, and of individually earned accounting fees. The calculations of the memo, which also deducted some $45,000 for investment income, increased Faggen's income for that year from $288,494, the sum reported, to $571,476.

A second and final meeting between Faggen and Kaufman took place on October 2, 1968. Faggen brought to this meeting the tax returns for all his four companies for the past five years, and the companies' client ledgers

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[1] Titan now claims that though all parties knew that close personal and professional ties existed between Faggen and Robinson, there was a hidden conflict of interest in that relationship, and that Faggen had a duty to disclose the extent of their business connections. After the initial introductions, Robinson took no part in the subsequent negotiations leading to the execution of the contracts. Any claim of a conflict of interest damaging to Titan is a completely frivolous claim.

and employment records. After examination of the tax records and discussion of possible adjustments, the meeting concluded with a tentative agreement on the acquisition, subject to approval by Titan's Board of Directors and a further working out of the details of the contract. The agreed-upon price of the Faggen companies was $5,500,000, to be paid in 10-year 4% convertible notes of Titan. The principal sum was ten times the estimated adjusted annual earnings of the Faggen companies.

Prior to a meeting of Titan's Board of Directors on October 9, 1968, Faggen, at the request of Kaufman, prepared another memorandum which was to be presented to the board. The memorandum briefly described the companies and placed some emphasis on the computer system under development there. Accompanying the memorandum were two exhibits: one showed pre-tax adjusted net income for the preceding four fiscal years,[2] and the other was an analysis of new clients. Copies of this memorandum were not distributed at the board meeting, but Titan's president, Frank, orally presented the earnings figures and the securities holdings of the Faggen companies.

The board approved the Faggen acquisition at this meeting but reserved a final approval pending an analysis of it by the executive committee. Subsequent to the board meeting Kaufman and an associate in Robinson's law firm prepared the contract. McIntyre, Titan's treasurer-direc-

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[2] Titan argues that Faggen's failure to comply with both generally accepted accounting principles and S.E.C. accounting rules in this exhibit was misleading as a matter of law. The statement of "Net Income—Pre-tax Adjusted to basis which will prevail after acquisition" simply states adjusted earnings figures for the fiscal years 1965-1968. There is no breakdown of these figures into various categories of income. The adjusted earnings of the various companies differ from those stated in the September 6, 1968 memorandum, although the earnings for 1968 are virtually identical. The income statement is clearly only a presentation of rough bottom line figures and not a financial report to which accounting principles and rules apply.

tor, and another Titan employee reviewed the financial basis of the transaction and found the Faggen adjustments to reported income to be reasonable. On December 2, 1968 the contracts were executed.

Difficulties arose after the merger. A disappointed employee of Faggen left immediately afterward, taking with him some clients. The data processing system encountered high startup and hardware expenses and never became profitable. Nonetheless, the actuarial side of the Faggen companies continued to show good profits. Titan between 1968 and 1972 withdrew $2.1 million in cash and securities from them. In 1972, Titan, under new management control, notified Faggen that Titan was no longer going to pay interest on his notes and commenced this action to rescind the contracts. Faggen treated the non-payment of interest as a default, and counterclaimed for the principal sum of the promissory notes and for accrued unpaid interest thereon.

The appellant's principal contention is that there were material misrepresentations and omissions by Faggen in the memorandum presented by him at the first meeting between Kaufman and him and in the memorandum prepared for presentation to the Titan Board of Directors. These alleged failings involve primarily the adjustments to earnings, the analysis of clientele, and the capacity of the computer program under development. The adjustments to income reflected anticipated earning increases that a publicly held company attempting to maximize income would realize after succeeding to the management of a privately held company which had minimized income for tax purposes. Titan complains that in three areas—pension funding, salaries, and travel and entertainment expenses—no reduction in expenses occurred, and that in his original memorandum Faggen had misrepresented potential savings. In the memorandum prepared for the board meeting, Fag-

gen had stressed the computer program under development and had listed new clients of his companies. Titan claims that this memorandum had misrepresented the present capacity of the computer program and had failed to list lost clients.

After a bench trial, Judge Tyler rejected the claims of Titan, and found that Titan had not relied in any way on Faggen's representations. The inducement for the contract, the judge found, lay elsewhere: that Chairman Robinson was strongly in favor of the acquisition, that the Faggen companies had a good liquid asset position, that the Faggen companies were profitable, and that the possibility of melding together actuarial and real estate companies was attractive. He found that these broad considerations, rather than interstitial details of client lists or of immediate data processing capacity, sparked Titan's acquisitive interest. As to the adjusted earnings statements, the trial judge found that Titan was aware of the basis of the adjustments; and was aware, or should have been aware, from the tax returns that the bottom line figures included, rather than excluded, investment income. He found that Titan was interested during the preliminary discussions with Faggen, and subsequently, in the financial analysis of his companies in but rough "ballpark" figures and that the only purpose the memoranda was to serve was that of providing an approximation of what the Faggen companies would earn through the elimination of certain expenses if the companies were publicly, rather than privately, owned.

Tending to buttress the absence of any determinative reliance upon Faggen's representations the judge pointed out such factors as the relative position of the parties, their arms-length negotiation, and Titan's long opportunity to examine the financial status of the Faggen companies prior to closing the deal. Furthermore, Titan advances no claim that there are material misrepresentations

or omissions in the sections of the contracts detailing the seller's representations and warranties.

Although Titan vigorously contests the bases for these findings of fact, we conclude that Judge Tyler's findings are amply supported by the record, and are not clearly erroneous findings.

On this appeal, Titan argues that reliance is no longer a requisite element in Rule 10b-5 actions involving omissions alleged to be material when it is shown that facts alleged to be material were not disclosed. This result derives, it is contended, from the Supreme Court's decision in *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972). That case involved Rule 10b-5 claims predicated on the non-disclosure of material facts to Indian sellers of corporate stock by the transfer agent bank employees who were themselves profiting through the sales of the stock to non-Indians. The Court, imposing liability on the bank and its employees, stated

> [u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. Id. at 153-154.

By this language the Court, rather than abolishing reliance as a prerequisite to recovery, was recognizing the frequent difficulty in *proving,* as a practical matter, that the alleged misrepresentation, allegedly relied upon, caused the injury. The parallel elements of materiality and reliance both serve to restrict the potentially limitless thrust of Rule 10b-5 to those situations in which there exists a causation in fact between the act and injury. *Globus* v. *Law Research Service, Inc.,* 418 F.2d 1276 (2 Cir. 1969),

cert. denied, 397 U.S. 913 (1970), *List* v. *Fashion Park, Inc.*, 340 F.2d 457 (2 Cir.) cert. denied, sub nom. *List* v. *Lerner*, 382 U.S. 811 (1965). Causation remains a necessary element in a private action for damages under Rule 10b-5. *Shapiro* v. *Merrill, Lynch, Pierce, Fenner and Smith, Inc.*, 495 F.2d 228 (2 Cir. 1974). Unlike instances of affirmative misrepresentation where it can be demonstrated that the injured party relied upon affirmative statements, in instances of total non-disclosure, as in *Affiliated Ute*, it is of course impossible to demonstrate reliance, and resort must perforce be had to materiality, i.e., whether a reasonable man would attach importance to the alleged omissions in determining his course of action.

In cases involving non-disclosure of material facts, even when coupled with access to the information, materiality rather than reliance thus becomes the decisive element of causation. See, e.g., *Metro-Goldwyn-Mayer, Inc.* v. *Ross*, ——— (2d Cir. 1975), Dkt. No. 73-2271, Slip op. at 1315; *Stier* v. *Smith*, 473 F.2d 1205 (5th Cir. 1973). And determination of materiality allows logically an inference of reliance. *Chris-Craft Industries Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341 (2 Cir.), cert. denied, 414 U.S. 910 (1973). See, generally, Note, 88 Harvard L. Rev. 584 (1975).

This case is not an appropriate one in which to find materiality in the light of all the circumstances. This is a case both of alleged misrepresentations and of alleged material omissions. We view Judge Tyler's findings as determining that there was an abundance of evidence of the matters the plaintiff really considered important in entering this face to face transaction, that while the omissions might, in other circumstances, have been deemed material, the omissions were not material in these circumstances. These findings were not clearly erroneous, and correctly applied the applicable law.

Titan raises a number of objections to the trial court's award to Faggen on his counterclaim of the full face amount of the notes, $5,500,000, plus interest to the date of the judgment.

In exchange for his four actuarial businesses, Faggen received 4% Convertible Installment Notes to be paid in five yearly installments between 1974 and 1978. The 4% interest was to be paid semiannually. Conversion rights, potentially valuable, gave Faggen the option to exchange the bulk of his notes into common stock of Titan at the basic rate of one whole share of stock for each $20.00 of unpaid interest. The remainder was convertible at $15.00. Upon fifteen days' written notice and at the option of Faggen, a default in the payment of any installment of interest or principal accelerated the maturity of the outstanding notes.

Titan, simultaneously with the commencement of this action, defaulted on the payment of interest, and now claims that the acceleration clauses in the Faggen notes violate Section 29 of the Securities Exchange Act of 1934, 15 U.S.C. § 78(cc). We do not agree with Titan. Titan need not have defaulted before seeking rescission and the acceleration clause in the Faggen notes does not prevent the federal court from adjudicating upon all the issues involved in this case.

Titan further objects to the award of the entire face amount of the notes. It claims this to be an excessive penalty which includes hidden unearned interest rates. The main prop of this argument is the statement of Faggen's expert witness, Shinagel, that at the time of acquisition the notes had a then cash value of $3,200,000. Faggen however did not receive $3,200,000 in 1968; he received promissory notes of the face amount of $5,500,000 with potentially valuable conversion rights. In return for its

promised liability on these notes Titan received four profitable businesses, a corporate stock portfolio with liquid assets in excess of $1,000,000, and a five-year period before it was required to make any payments on the principal indebtedness.

As to Titan's claim on this issue, we are unable to disagree with the position taken by the trial judge who found that here, on these facts, there was no concealed interest rate, and that the acceleration of the notes did not constitute a penalty against Titan.

Finally appellant argues that Judge Tyler when allowing Faggen's counterclaim against it, improperly refused to allow its claims of set-off against Faggen because clients were diverted from Titan. The record simply does not support this allegation.

Affirmed.

Judgment of the Court of Appeals.

UNITED STATES COURT OF APPEALS

FOR THE
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the first day of April one thousand nine hundred and seventy-five.

Present: HON. STERRY R. WATERMAN
HON. JAMES L. OAKES
HON. MURRAY I. GURFEIN
Circuit Judges

74-1694

Titan Group, Inc.,
Plaintiff-Appellant,

v.

Harold Faggen,
Defendant-Appellee.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in accordance with the opinion of this court with costs to be taxed against the appellant.

A. DANIEL FUSARO,
Clerk

By VINCENT A. CARLIN,
Chief Deputy Clerk

APPENDIX B

Findings of Fact and Conclusions of Law, Tyler, U.S.D.J.

There will follow what shall be deemed my findings of fact and conclusions of law pursuant to Rule 52 FR Civil P.

Under contracts closed on December 2, 1968, the plaintiff Titan acquired from the defendant four companies known as Harold Faggen Associates, Inc., Actuarial Tabulating Corporation, Employee Fund Services Corporation and Fund S & E Corporation. Specifically, of course, Titan acquired the capital stock of these four companies from defendant Harold Faggen in consideration for the issuance to him by Titan of $5.5 million worth of convertible debentures bearing interest at four percent per annum.

Although the convertibility details varied slightly, suffice it to say, the debentures would be convertible by Faggen at an average price of $19 a share.

In the fall of 1968 as I understand the evidence, the common stock of Titan was trading at roughly from 15 to 17½ points.

In May 1972 after a prolonged period of bickering between the parties, Titan notified Faggen it would no longer pay interest then due and owing on the debentures. At about the same time, it commenced this suit in this court seeking rescission of the contracts and money damages.

Based upon claims of violations of the Securities Exchange Act of 1934, 15 U.S.C. Section 78(b) and Rule 10b-5 thereunder 17 CFR 240.10B-5.

Defendant reciting the default on the notes has counterclaimed to recover the full value of the debentures plus outstanding interest.

I propose to treat first the negotiations and other events prior to and leading up to the closing on December 2, 1968.

Titan is a comparatively small conglomerate which in 1968 was basically in the real estate and construction business. With the boom market of that year, Titan was very interested in acquisitions of other companies. Then as now, it was in an exceedingly tight cash position. Moreover, at that time and over the years to date, Titan has sustained several changes in equity control and even more changes in top management.

Early in 1968, Titan had come under the dominance of what is known and as was referred to in this trial as the Block group. That group installed Anthony Frank as president of Titan in the spring of that year. Benjamin Robinson then as now a New York lawyer although not literally a member of the Block group was and continued to be chairman of the board of Titan. A long standing associate and business acquaintance of his was the defendant Harold Faggen. Harold Faggen is a law graduate, albeit, as far as I can determine, he has never been a practicing lawyer. He is also a certified public accountant and actuary and his field of expertise, basically, has been in the accountancy profession.

In 1968 he was the successful owner and executive head of an actuarial business. The core of his business success then was the acquisition and retention of many clients, particularly unions and union pension and welfare funds.

Essentially at that time the bulk of his business was done under the name and style of Harold Faggen Associates, Inc. As indicated heretofore, however, Faggen also did business through three other corporations, the stock of which he owned and those corporations I named earlier.

As stated, he and Ben Robinson had close business and professional contact. Indeed, several of the unions and pension funds represented by Faggen as an actuary happened also to be represented by Robinson or his firm as counsel.

When Frank and the Block group came into the picture in early 1968, Frank who had been a California real estate

operator and his board of directors were interested in acquisitions. This is not surprising because if you will recall and certainly this Court takes judicial notice of the fact that 1968 was one of the peak years of conglomerate activity and acquisition activity and there was a relatively boom market in that year.

A friend and associate of Frank at the time was Edmund Kaufman, a Los Angeles lawyer and member of the law firm of Irell & Manella. Kaufman purported to be and in fact I deduced was a specialist in mergers and acquisitions.

In 1968, the Faggen companies had enjoyed a very strong cash and liquid asset position. In particular, their actuarial business, albeit relatively small perhaps from certain points of view was nevertheless very successful.

Not surprisingly, therefore, Harold Faggen had received a number of overtures for the acquisition of his business or a merger from such substantial firms as Price, Waterhouse and more particularly, Levin Townsend and Diebold Corporation. Thus, in the second quarter of 1968 with the assistance of a man named Rogoff working for Diebold who prepared projections of income for the Faggen companies which among other things recognized distinctions between accounting for private firms and for public firms, Faggen made presentations to these companies just mentioned.

In the course of these discussions, particularly with Levin Townsend and Diebold, it appeared that these firms had suggested, albeit not firmly offered figures from five million to seven million to acquire the Faggen companies. Faggen discussed these conversations and tentative negotiations with his friend Ben Robinson, who lost little time in putting Faggen in touch with Anthony Frank. Both Robinson and Frank made it reasonably clear to Faggen that Titan would be interested to acquire his companies.

As a result, Frank had Kaufman come to New York from Los Angeles and take up discussions with Harold Faggen. Their first meeting of substance came on September 6, 1968 in the Robinson law offices on Park Avenue, New York City.

As far as I can tell, no specific price was discussed or certainly was not negotiated that day between Kaufman and Faggen, but it does appear that Kaufman looked over what is in evidence as Exhibit 1 in whole or in part, a set of projections prepared in large measure by Rogoff and Faggen.

More than that, Kaufman looked over the tax returns of the Faggen companies for 1968. They discussed in general the actuarial business and the prospects for the Faggen companies, at least in theory, in the field of data processing.

A much more significant and detailed meeting occurred thereafter on October 2, 1968, also in New York. Frank was apparently present at this meeting for a relatively brief time but Faggen and Kaufman were the principal participants. Faggen and Kaufman went over the Faggen company tax returns for the previous four or five years. They also appeared to have discussed the balance sheets at least to the extent of the cash position or net worth of the Faggen companies.

There then followed another meeting on October 6 and this one was principally concerned with conversation between Frank and Faggen; and at the request or Frank, Faggen delivered to him, Frank, a handwritten memorandum of a brief narrative and statistical summary of accounts of the Faggen group and their employees at least in terms of numbers.

There was also apparently a pro forma which was prepared by Faggen or someone in his organization which was part of that exhibit, which we know as Plaintiff's 2.

Frank thereupon proceeded to have that particular document typed up and that is in evidence as we know it as Plaintiff's 3.

Going back to October 2, it appears that at the conclusion of that meeting, both Faggen and Kaufman shook hands on a tentative deal which would be subject to board approval and the working out of specific details by financial and legal representatives, particularly of Titan.

Now, it would also appear, although it is not entirely clear because of certain equivocal testimony both by Mr. Kaufman and in my judgment Mr. Faggen, that it was at the October 2 meeting that Kaufman took the income for 1968 and estimating the adjusted pre-tax income from those figures to be about $550,000, negotiated Faggen down from a price originally suggested by Ben Robinson of about $7 million when he first talked to Frank and Faggen about this matter. As Kaufman put it, therefore, he negotiated Faggen down to a price of $5.5 million in convertible debentures. Though much has been made of this figure and how Kaufman relied upon it, I think his principal reliance was to get Faggen down to that amount even though he may have used the figures as plaintiff argues, and it was a technique perfectly acceptable among professionals in order to get a rough approximation which in turn would lead to a good price.

Although Kaufman may have been understood to claim otherwise in his testimony at this trial, it is specifically found that he did not rely really in any way on the so-called projections of earnings which we know as Plaintiff's 1, nor did he rely really on what is called the pro forma attached to Plaintiff's 3. First of all, he didn't have that pro forma Plaintiff's 3 because that didn't appear until the October 6 meeting.

Second of all, even assuming he was reading the same figure, for example, of 1968, which does appear on Plain-

tiff's Exhibit No. 1, the so-called Faggen-Rogoff projections, I don't think that Kaufman relied on those at all in coming to a handshake tentative agreement with Harold Faggen. The reasons for this are many, but I can summarize briefly at this moment to say that Kaufman understood full well that this was a deal which was attractive because it was an acquisition and it looked as though the actuarial business might be put together very neatly with some of the mortgage and real estate business which Titan was already into, and that possibly there was a chance for some data processing melding which in the future would be potentially exciting and profitable. More than that, I think Kaufman was bemused as many other persons were bemused by the strong asset and cash liquid asset position of the companies of Harold Faggen.

Now, as stated on October 6, Frank, as he put it, got very excited about the figures, most particularly in respect to the net worth of the Faggen companies. Also as Frank put it, he was excited about the possibilities that might be made or put into effect once the Faggen group was merged into Titan to build upon the computer capacity such as it was of the Faggen companies.

Frank was also aware, as was Kaufman, that Ben Robinson, chairman of the board wanted this deal and therefore he wanted to do the best he could to see to it that this deal was sold to the board of directors.

I believe that largely for this reason, he asked Faggen to prepare a presentation and give it to him the following day and as indicated, this was done and as a result, Plaintiff's 3 came into being.

Two days after October 7 and on October 9 was held the board of directors meeting which, inter alia, took up the question of the Faggen group acquisition.

According to plaintiff in this lawsuit, the board members relied heavily on the pro forma of earnings which were

typed up and incorporated in Plaintiff's 3 in evidence but this claim is substantially undercut by a number of other matters of evidence in this case. To begin with, although the plaintiff argues otherwise, the minutes of that board meeting by no means indicate that this was so. Beyond that, the plaintiff called a number of director witnesses, that is, witnesses who had been directors in the fall of '68 at the time when Titan made this acquisition. Only one of these witnesses, Frager, recalled any discussion of earnings at all at this meeting and he wasn't particularly explicit on just exactly what was said and even if I am wrong on that, it is abundantly clear from any fair reading of Frager's testimony, that this wasn't as important as such other facts as the fact that Chairman Robinson wanted this deal and that Titan was in a cash position of a very tight nature and here was an acquisition which would pick up between $1 and $1.3 million cash.

Now, it is true, however, that at that board meeting, Frank had with him Plaintiff's Exhibit 3. It is also true that he did not physically distribute this to the board members. The only evidence that any board member ever saw this document within its four corners is the testimony of witness Hegy, a member of the board who was not present at the October 9 meeting. He was away, he came back after the board voted on this acquisition and Frank did present to him for his consideration and reading the exhibit which we know as Plaintiff's 3.

Obviously this had nothing to do with the decision of Titan to acquire the companies because Hegy only read it after the fact.

Suffice it to say that the board of directors on October 9 voted to acquire the Faggen companies subject to investigation and approval of the financial and other details by the executive committee of Titan and by the Robinson firm in respect to legal matters.

Of considerable interest and importance is the fact that between October 9, the date of the board of directors meeting and the date of the closing December 2, 1968, two financial and accounting employees of Titan Messrs. McIntyre and Russo, checked into the financial data and records of the Faggen companies. Although it could be argued that each of these gentlemen, particularly Russo, have taken a markedly different position in connection with their testimony in this trial, or prior to trial in depositions, it is certainly beyond any serious dispute that at the time, that is, at the time between October 9 and December 2, the closing date, they raised no quarrel or difference of opinion with the figures submitted by Faggen or any of the books and records which they had a chance to look at.

While all this was going on, the Robinson firm representing Titan and Mr. Simon Sheib of the firm of attorneys representing Faggen in this very lawsuit negotiated the contract as a formal matter after Kaufman out in his office in Los Angeles, apparently, had prepared a first and rather rough draft. This draft was mailed by Kaufman back here to New York to a Mr. Rosen, I think, in the Robinson law firm. In the course of the lawyer's work, it was agreed Titan would buy the Faggen companies against the tax returns for the last five fiscal years of those companies and also against the unaudited financial statements of the companies prepared by Joseph Warren Company, a certified public accountancy firm, for the quarter ending September 30, 1968.

I should say parenthetically, but importantly, as it is, the plaintiff has not even attempted to offer or if they have, offered any persuasive evidence that those particular contract document financial statements as set forth in paragraph 3 of the contracts of acquisition contain anything of significance or materiality which was false or misleading at the time they were made.

After the changes in the contracts were made and the negotiations between Mr. Sheib for Harold Faggen and the Robinson firm for the corporation and after Russo and McIntyre had made such inquiries and studies as they made, it appeared that the executive committee of the corporation must have approved this, although the record is notably thin, if not indeed virtually silent on just what the executive committee did do as a formal matter for Titan, once the board meeting of October 9 had been completed.

The closing took place in any event without any difficulty on December 2, 1968.

Almost literally within a week or two after the closing, I should note that an employee of some ten years of the Faggen group, a man whose job was called a consultant, and he was one of five or six consultants to the Faggen group, by the name of Tabor quit his employment and took with him some of the clientele of the Faggen group. Harold Faggen brought this to the attention of other management of Titan and not long thereafter, a suit was commenced by Titan against Tabor and his new employer which was none other than the Levin Townsend firm, by the way, and with not too long a delay, that litigation was settled rather profitably it seems to me whereby the defendants paid approximately 260 or $265,000 to Titan.

As 1969 arrived, events seemed to move along at first smoothly enough but then later that year, as the stock market started downwards, the problems of Titan and all of its activities appeared to become more apparent and binding.

As far as the record shows, the actuarial business of the Faggen group as it was literally called by the Titan executives, continued to do a strong business. Kaufman by this time had become chairman of the board since he was part of the so-called Block group. It is true that there is evidence that Kaufman in 1969 became somewhat dissatisfied

with the data processing efforts of the Faggen group. In a sense you could argue that this is curious because Kaufman himself as I understand the proof had been told by Faggen in September or at the very latest on October 2, that there would be a flat year for the Faggen group in the processing end because of the start-up costs and new hardware expenses among other things.

I think the same warning incidentally had been conveyed by Faggen in the presence of Anthony Frank. In any event, Kaufman seems to have been a little unhappy as he was unhappy about a down-turn of business in virtually all of the divisions of the Titan group.

In the meantime, also, as 1969 went along, Kaufman himself began to engage or, I should say, encounter heavy weather in arguments in the Titan group family. Indeed, he finally left Titan as chairman of the board in the spring of 1970 and he did not leave in what I would call an aura of good feeling. He was then succeeded by none other than the aforementioned Mr. Frager of St. Louis as chairman of the board and then there was a gentleman for a period of a month or two by the name of Rosen, Harry Rosen and finally and unhappily as event turned out from the Harold Faggen selfish point of view, Mr. Robert James Frankel became chairman of the board. Frankel had first come into contact with Titan through a friend of his who was a member of the Robinson law firm. This was in the spring of 1969. Frankel was successful in negotiating the sale to Titan of a construction company of his known as Soverign Construction Company. He was elected as a director of Titan in 1970 at the annual meeting of the stockholders and not long thereafter, in February of 1971, Mr. Frankel became chairman and chief executive officer of the Titan group. Not surprisingly, since he assumed the latter office, he came smack up against one of the usual bugaboos of the Titan group, lack of

cash. At about the same time he met Harold Faggen and in all places, the Yale Club, and immediately he tried to get Faggen and his so-called Faggen group to cast up more cash for the parent company. At least in human terms, it is not surprising to learn that Faggen reminded or pointed out to Frankel, that Titan had acquired at least $2 million worth of cash and marketable securities after the Titan group had acquired the Faggen companies.

Indeed, between 1968 and 1972, Titan withdrew at least $2.1 million in cash and securities from the Faggen Companies, and that therefore he was not at all enthusiastic in weakening the Faggen group operations by contributing more cash.

Partly because of Faggen's adamance in this position, Frankel in April 1971 sought to prevent Faggen from being re-elected to the board of directors. This I am sure did not endear Frankel to Faggen and I surmise there were some personal differences between the men which are, from what I infer from the evidence and see from their demeanor in the courtroom, probably understandable on both sides. Even more important, perhaps, Frankel ran up against another difficult problem and that was how to pay the interest at 4% which was falling due from the Titan group to Harold Faggen on his convertible debentures.

In May 1971, therefore, Frankel sought, as he testified, to have Faggen see to it that the Faggen group took out of their coffers cash to pay Faggen personally on his notes. Faggen was notably unenthusiastic about this, according to Mr. Frankel and I assume this is correct and as a matter of fact, in the summer of 1971, there were special board meetings and other conversations of an informal nature devoted to the problem as Frankel saw it of the interest due to Faggen on his notes.

Relationships were not advanced by the initial fact that it was during this period that Frankel asked Faggen to

cut back on his data processing business and not acquire new clients for that kind of business unless those new clients were willing to underwrite their own start-up costs.

Thus by the fall of 1971 at the very latest, relations between Frankel and Faggen, to put it kindly, were strained. Indeed, Frankel was already casting around for information and legal assistance so that he could make claims against Faggen and Benjamin Robinson.

In December 1971, Harold Faggen's employment contract which was executed as part of the acquisition of the Faggen companies expired by its terms and Frankel with admitted reluctance extended Faggen on a month-to-month basis only. To make matters even worse, nature intervened in the form of exposing Faggen to a rather serious illness which required him to be operated upon and thus away from the business for a significant period of time in the winter of '71, '72.

The handwriting it seems to me was then on the wall and in April 1972, Faggen found himself no longer a member of the board of directors of Titan and as heretofore indicated in May of 1972, the Titan group commenced this suit after they had notified Faggen that they were no longer going to pay any interest on his notes.

Now, briefly summarized, plaintiff's principal contention in this federal court litigation is that Harold Faggen made knowingly false material statements concerning the financial and business facts of his four companies upon which Titan relied prior to the execution of the contracts on December 2, 1968 in acquiring the capital stock of these Faggen companies in exchange for $5.5 million worth of convertible debentures issued to Faggen.

Put differently, in lawyers' terminology of a simple kind, plaintiff claims there was fraud in the inducement and that this was not only a violation of Rule 10b-5, but it was also common law fraud of the most egregious nature.

Specifically, Titan contends that the income figures set forth on the pro forma attached to Plaintiff's 3 in evidence were knowingly false in a materially significant way. According to Titan group, its accounting experts who have testified at trial and who prepared various financial documents and computations relating to the condition of the Faggen companies in the year 1965 to and including 1968, which computations were made of course after the commencement of this lawsuit, have proved that the figures submitted by Faggen in what we call Plaintiff's Exhibit 3 to be materially false and intentionally so to the knowledge of Faggen.

In addition, Titan makes a number of other contentions, some of which this Court regards as bordering on the absurd as follows:

Faggen was and is guilty of a conflict of interest in that he did not advise the Titan negotiators and representatives that Ben Robinson had represented him or his companies as a lawyer and that there had been a long relationship whereby they both represented the same unions or the same union pension funds.

Additionally, it is claimed that Faggen falsely stated that he and his companies had in being, a model for a computer program for the pension plans of small accounting firms, small law firms and their clients.

Additionally it is alleged that Faggen falsely covered up the fact he had lost substantial clients in 1968 and there was a clear danger of losing other major clients in the foreseeable future.

On the other side of the coin, the defendant has contended that there is no truth in these allegations as a matter of fact. Beyond that, the defendant has claimed that this suit is time barred. Defendant has also claimed that plaintiff has no right to prove anything that went on before the contracts were signed because of the parol evidence

rule or because as it is sometimes put, that whatever negotiations took place between Faggen on the one hand and Kaufman and Ben Robinson perhaps, and certainly Anthony Frank, merged into the formal contract documents.

Now, although as will be seen hereinafter I have considerable difficulty in finding that plaintiff has proved by a preponderance of the evidence that Faggen made knowingly false material statements or purposely withheld material information which was necessary to make the picture complete in his negotiations with Titan group, this Court concludes that Titan by its officers and directors did not rely substantially upon any of the information which plaintiff now claims that it did, but before we get to these ultimate conclusions of fact and conclusions of law, I want to take up two points which were argued eloquently in the course of the argument.

First of all, as you gentlemen know, the Court specifically raised the question of jurisdiction. Suffice it to say basically that I agree with the plaintiff. I believe the plaintiff has proof sufficient to show jurisdiction. In more detail, as we know, the Courts have interpreted very loosely the requirement of the statute on Rule 10b-5 that an instrumentality of interstate commerce or the mails be used directly or indirectly and as good a case as any in thiscourt recently is a case called Heyman versus Heyman at 356 F. Supp. 958, decision by Judge Bauman.

Here as Mr. Powers accurately pointed out, I believe there is ample evidence of use of mails and of interstate phone calls between Kaufman and Frank perhaps on the one hand and Faggen on the other. More than that, certainly I think every inference should be to the effect that Faggen well knew that there would be use of the mails between Los Angeles and New York and that there would be use of the phone in arranging the particulars of this transaction. Therefore, I think the plaintiff is clearly

correct and that this Court has jurisdiction under the statute on Rule 10b-5 in that sense.

The other point I would like to take up now is the very interesting and much more difficult argument of the defense based upon the statute of limitations and perhaps laches as well.

I can well understand the position of the defendant on this score because there is ample evidence form which one might infer that the plaintiff Titan group wasn't misled or lulled at all. As a matter of fact, if one looks at the records, let alone the testimony, as late as March of 1970, Titan group was representing to the world through its annual reports and materials filed with the Commission, I assume, but at least in its annual report, that this was an arm's length deal which Titan group had investigated carefully before they made these contracts with Harold Faggen. Moreover, we have the evidence already discussed that McIntyre and Russo looked into this and never thought that anything was wrong and never told anybody that anything was wrong.

Still further, as defense counsel argued this morning, if all of these things were as terrible as has been argued here, you would have thought that the defection of Tabor within a matter of days after the contracts were signed, if there was really any lulling, might have made the management sit up and take note.

On the other hand, from all of that, I still end up siding with the plaintiff. I think there is sufficient here to show that a federal court, of course, in the first instance must look to New York law since the statute does not have any limitation period. Once it does that, it doesn't willy-nilly end up with the contract provisions saying that March 31, 1970 is the absolute cut-off for any claim or suit in connection with this acquisition.

I think I should give the plaintiff the benefit of the doubt for such reasons as, presumably, as plaintiff argues,

it really wasn't until Frankel came in that the management possibly was sufficiently independent from the power of Ben Robinson and Harold Faggen to really look into this.

I also think a federal court—would as a policy matter, be unwilling to give literal effect to that application of the contract provision in question even though that is supported by a provision of New York Statutory Law, but I think the federal policy considerations would be more weighty, that a federal court ought to decide the merits rather than taking the technical position under these circumstances that a plaintiff is forever cut off absolutely as of March 31, 1970.

In any event, I side with the plaintiff on this issue and think that it is appropriate to turn to merits, but I will say that it is a very interesting and closer question than perhaps I at least initially thought it was when I first heard it from Mr. Cooper when this case was first assigned to me.

I might point out in order to determine when the statute of limitations begins to run, the Courts have held that Federal law must be applied, and that is one of the good legal reasons why I think the argument of the plaintiff in this respect probably ought to carry the day.

In other words, the first exercise is to look to the appropriate precise limitation period and there we look to the law of New York.

The next step, of course, as just stated, is to determine when that statute of limitation period begins to run and there I think the case agree that Federal law should be applied.

Given the liberal Federal policies in this area, I think the better view is to favor the plaintiff and say that this case is not time barred by the statute of limitations. That is not to say, however, that some of the laches arguments

or the argument by the defense that this is nothing but a contrived lawsuit should be totally ignored when this Court turns to the merits.

There are a variety of reasons why I think reliance or lack thereof is the key to this case. As we have all agreed in the course of colloquy and argument; this is not a case brought by a shareholder of a public company who had no benefit of face-to-face dealings with the contract or the contracts in question. As was pointed out in Chris Craft Industries vs. Piper Aircraft, Second Circuit, 480 F2d 341, 371, cert. denied 414 U.S. 910 (1973), where the transaction is accomplished through impersonal dealings such as on a stock exchange or for some other reasons the factors that influence the parties are not readily apparent, the decisions have discussed liability in terms of the materiality of the misrepresentations. This is sometimes referred to as the objective standard and has also been used in class or injunctive actions, but in individual damage actions as I read the cases, proof of reliance, is still required. As good a case as any on this is List versus Fashion Park, 340 F. 2d 457, 462 cert. denied 382 U.S. 811 (1965). There it was held that the individual plaintiff must show both that he relied on past misrepresentations and that a reasonable investor would have relied.

The fact that the plaintiff was an experienced and successful investor was was taken into account in List.

A similar case is the Third Circuit decision Kohn versus American Metal Climax, 458 F. 2d 255, 290.

In any case. whatever the circumstances and facts may have been in all the case law that we know of and certainly in the two cases I cited, if here there was a case where reliance ought to have to be proved by a preponderance of evidence, it is here. We had sophisticated parties. Indeed the balance of sophistication and know-how rested heavily in favor of the plaintiff, Titan group. This was a face-to-face deal and even Titan group as late as early 1970 was telling everybody in the world who would read their annual reports that this was so. It was put on a proxy statement in that year and that document, of course, was distributed to the public after approval, presumably, by the Securities and Exchange Commission.

I am totally unpersuaded or I certainly am not persuaded by a preponderance of the evidence that there was any such great reliance as Titan group now argues on the pro forma attached to Plaintiff's Exhibit 3. I believe the real reliance was in quite different areas, such as number one and perhaps most importantly, the fact that the Faggen group seemed to have a good going business which nobody even to this day denies was the fact and that it had a very strong net worth.

Two, I think the major reliance was on the good word of chairman of the board Ben Robinson who at least at that time was a highly respected and potent force on the Titan board.

Three, I think that none of us can ignore the clear intent of particularly the Block group as represented on the board and I dare say every other member of the board to not only get Titan in a better cash position, but to make acquisitions and grow, grow, grow. 1968 was a big conglomerate year, generally, and the Titan board of directors was no exception to what was going on at that particular time.

Four, I think there is some truth in what the plaintiffs argue but I don't draw the adverse conclusions that plaintiff does. I think there was considerable interest as Anthony Frank said in trying to put together the actuarial business with the mortgage and real estate business of the Titan group already existing and more than that, to build a data processing operation which would meld both the actuarial, accountancy and mortgage and real estate details in the same operation, but I don't think Frank for one minute assumed or was told by Harold Faggen that that capacity

already existed in the Faggen groups. I don't think for one minute Anthony Frank failed to understand that the computer hardware and existing programming in the Faggen companies was comparatively small and unsophisticated and that is that.

I don't think that the Titan group had the slightest interest, really, in the details of the numbers of clients and whether they were inter-related clients in the sense that the unions quite obviously had something to say of who or what firm would be accountants for the union pension funds. I don't think that anybody cared the slightest about that. Everybody was relying on the know-how of Ben Robinson, who after all had considerable union business which he brought into his law firm, and Harold Faggen seems to have similar and maybe even better business from an accountant's point of view and that is all anybody cared. Whether it was 140 clients or 70 clients and whether Harold Faggen had lost ten percent of his clients the year before or was about to lose 20 percent of his clients, they couldn't care less and nobody kidded anybody on that score.

As far as conflict of interest is concerned, although I really believe the plaintiff has effectively abandoned that argument, that is a reductio ad absurdum.

No one was bemused about the close relationship between Robinson and Harold Faggen. That is part of the reason the deal was sold and that is part of the reliance.

Second of all, there is nothing wrong in the law or in the canons, if there are any canons available, and they certainly weren't made available to the Court at the trial, in the accountancy industry, but I will take note of the fact that it is unlikely there are any canons which would say that it is wrong for an accountant to deal with a lawyer and in effect, each of them bring business one to the other.

Second of all, even if I assume that this ridiculous argument is factually correct as advanced by the plaintiff, I can only say that in 1968, if all those facts had been known

to the board, it may have even whetted their appetite more than it was already whetted for these particular acquisitions.

As I think of Mr. Powers finally came down to it today, everything except figures is totally unpersuasive, even to the plaintiff's knowledge. Sadly enough, I can understand this. There is no doubt that Mr. Frankel found Faggen a difficult man to deal with. I don't blame Frankel for that. I can surmise that Faggen is a little bit feisty and difficult and was probably a prickly rose to put it kindly, once he and Frankel started to argue over the interest due and the data processing business as Frankel saw it, as opposed to how Faggen saw it, but I am afraid that all of that has permeated this lawsuit. Both sides have been assiduous in covering each other with mud and like everybody else, we are dealing with human beings and there is a lot of mud around for both sides, particularly post-acquisition, but that doesn't help the proof of the plaintiff's case except in respect to perhaps the figures.

I have already held that the figures, really, are meaningless, at least to the extent that they were relied upon as plaintiff argues. However, I think in fairness, these figures are to be discussed and analyzed a bit.

It has been stated that Plaintiff's 1 contained and in fact it does, contain the 1968 income pre-tax for the Faggen companies to be about $571,000. That is true. Those schedules which Rogoff and Faggen prepared do show that.

I accept the argument of the defense, however, that Kaufman really didn't rely on this at all. Kaufman also understood, because he saw the tax returns, that there had to be significant adjustments made because on the one hand the Faggen groups were wholly-owned or private companies and therefore their accountancy and tax reporting methods necessarily were different than those of a public company such as Titan.

More than that, despite whatever he may have inferred at trial, certainly Kaufman knew that those figures probably embraced income earned from investments of about $1 million or slightly more in the portfolio of marketable securities held in the name of these Faggen companies rather than by Faggen individually.

We have heard a great many arguments and the witnesses have all been asked under direct and cross the significance of the handwriting that appeared on certain copies of Plaintiff's Exhibit B, that is, more particularly on the page which we know is the pro forma page and what is meant by "excludes investment income."

The plaintiff argues strenuously that this phrase written in the handwriting at one point of Mr. Ben Robinson and at another point by Mr. Frank indicates beyond peradventure that Faggen told these gentlemen that the pro forma figures excluded earned income from securities.

I am sorry to find flatly that there is no persuasive proof to that effect whatsoever. Admittedly, the picture is not entirely clear, but the plaintiff has the burden of proof here as it does across the board on its claims and I am more inclined to think that in the case of Robinson, although his testimony was a bit fudgy and cloudy on the point, that he really wrote that phrase down because he wasn't sure what these figures included, and as to Frank, I think he did the same thing. He wanted to find out and make sure and I am by no means convinced by a preponderance of the evidence that Harold Faggen told them orally otherwise.

As a matter of fact, if you look at the tax returns and you look at the other figures, it is virtually impossible for this Court to assume that the plaintiff could possibly be right on this argument because I cannot see how you could get $571,000 on any other basis except including investment income for the year 1968. Particularly so-called adjustments having to do with the over funded pension ac-

count, T & E, salaries of Harold Faggen and Rose Dogan which Titan group understandably submitted ought to be reduced and the like.

Though the picture is not as clear as a selfish matter you would like to see it as a finder of facts, I am certainly not persuaded that the plaintiff's version of all of this is in fact correct.

Thus, the reconstructed figures of the accountants who worked on this matter and who testified for plaintiff at this trial are suspect because they made certain assumptions in this area which I do not find supported clearly in the evidence. Not only that, although Mr. Powers is correct, I believe in suggesting that when Frank and Kaufman and Faggen were talking prior to October 9, 1968, they both were mixing up both accrual methods of accounting and cash methods almost necessarily. There is nothing wrong with that. It doesn't follow from that that the accountants who did the post-litigation commencement work here were following the same methods which the Faggen company books were kept on at the time of the negotiations in the fall of '68.

Not only that, as indicated, I think they made certain assumptions about the adjustments and certain assumptions about income from investment which are not clearly supported.

Finally, I can only note that this puts us in a position where we are comparing apples with oranges, which is not very persuasive evidence in my judgment in an important matter or question as to whether or not there was a material misrepresentation of the financial data shown on the pro forma.

I would be less than fair to plaintiff if I didn't admit there is a possibility that upon reconstruction using slightly different accounting methods, one could establish from an accountancy point of view that the figures ad-

vanced by Faggen in the fall of 1968 didn't prove out to the dollar. That I think is probably true, but I think any shrinkage from the $571,000 was far less than what plaintiff here claims which is the difference between some $404,000 and $571,000.

All of this is really of esoteric interest as it is because I cannot be at all persuaded that this is what was really relied upon by sophisticated bookkeepers like Russo and McIntyre—McIntyre put it very well in saying in effect that; "our real concern and only concern was to look at enough to make sure that these pro forma figures were within the ballpark." Plaintiff has not satisfied me by a preponderance of the evidence that the figures were anything but in the ballpark and ro one has shown me or no one has even attempted to show this Court that anybody tried to bamboozle Russo and McIntyre. I own to the fact that some of Harold Faggen's ideas of tax return preparation and reporting of individual income taxes do not accord with my notions as to how these things should be done. For example, I am not entirely sure that the T & E deductions that his records show or his companies' records show were entirely supportable from a private firm point of view, but again, this is all really meaningless because I don't think anybody in Titan group could have cared less about all of this detail in the fall of 1968.

Now, there is one other point I want to make and that is this. Mr. Powers, and the plaintiff have argued consistently if you look at page 2 of Plaintiff's 3, or the corresponding page on Mr. Faggen's handwritten version thereof, a real fraud appeared in the following language and I quote from paragraph 2 page 2, dropping the first clause of the sentence, "We are in the process of programming completely automated pension plan calculations for small and medium sized employers. We expect to provide these services to stock brokers, accountants and lawyers only."

I will assume at least arguendo that he was at least guilty of a little modest puffing but on the other hand, even accepting that construction of this language, I read it to indicate the fact, namely, that they didn't really have any completely automated program for pension plan calculations for small and medium sized employers, and as already indicated, I find specifically that Frank put this construction on this language and on any oral conversation he got from Harold Faggen. As Faggen understood and I don't blame him, I think I would have reacted the same way, this offered exciting possibilities, but that is all it offered. A further point on this; it wouldn't have made much sense for Harold Faggen to say as he did and Frank I think conceded this, that look, 1969 will be a flat year in the data processing end because we will have all these start-up expenditures and new hardware expenditures, and, therefore, I am afraid this is one of the gossamer arguments of the Titan group in this lawsuit.

On the basis of these findings and conclusions, I determine that there is no proof by the plaintiff by a preponderance of the evidence that the defendant Faggen was guilty of any scheme or artifice to defraud or that he made any untrue misstatement of a material fact or he omitted to state a material fact necessary in order to make the statements in fact made in the light of the circumstances under which they were made not misleading.

Therefore, the defendant is entitled to judgment dismissing the claims of the plaintiff and as our argument this morning indicated, there is no other defense to the notes. Therefore, the counterclaim which Harold Faggen asserts is granted and he is entitled to judgment on his counterclaim.

Opinion of the District Court.

TYLER, D.J.

Following this court's rendition of findings of fact and conclusions of law on March 19, 1974, the last day of the trial herein, defendant's counsel submitted a proposed judgment awarding damages on his counterclaim to the court on March 22, 1974. Several days later, on March 26th, plaintiff's counsel submitted a motion entitled "Motion Requesting Hearing on Issue of Amount of Damages". That motion and defendant's arguments in support of its proposed judgment were heard on April 8, 1974.

At the conclusion of argument on the latter date, this court ruled on certain branches of plaintiff's motion as and for the reasons set forth by the undersigned on the record. Briefly, those rulings may be summarized here as follows:

1. In agreement with counsel for plaintiff, this court refused to grant defense counsel legal fees as prayed in the amount of $250,000 or, indeed, in any amount until the record thereon is amplified and a hearing is held on that issue; and

2. The court denied the belated and spurious claim of plaintiff's counsel that plaintiff had reserved the right to try out before this court its claim (which is the subject of a pending suit in the Supreme Court of New York, New York County) that defendant kept "key clients of the businesses sold by himself and his mismanaging and diverting existing clients of the businesses to himself over the past two years."[1]

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[1] In effect, plaintiff's counsel argued: (1) a memorandum order of Judge Ryan permitted plaintiff to try these issues to this

(*footnote continued on following page*)

Decision was reserved, however, upon what appears to be a more significant issue—that of whether or not an award to defendant of the face amount of his convertible notes under the acceleration clause thereof amounts to an unenforcible penalty. Typically, plaintiff's counsel has submitted a welter of specific arguments and case citations, most of which appear to be irrelevant to the point; similarly, the reply papers of defense counsel do not cast up any discussion or authorities which are germane or helpful. Nevertheless, as will be seen hereinafter, independent research by the court suggests that the basic argument of plaintiff in this area deserves serious consideration.

This issue arises because defendant has requested judgment against plaintiff on his counterclaim in the amount of $5,500,000.00. together with interest of $878,535.68.

In return for selling his business to Titan on December 2, 1968, Faggen received Titan's 4% Convertible Installment Notes payable in five installments beginning November 1, 1978. The 4% interest was to be paid semi-annually, on May 1 and November 1 of each year. The notes could be converted for restricted stock at the basic rate of one whole share of common stock for each $20.00 of the unpaid principal[2] any time after January 1, 1969. At the time of plaintiff's acquisition of the Faggen companies, December

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(*footnote continued from preceding page*)

court, and (2) counsel specifically advised the undersigned trial judge that plaintiff was reserving such right at page 853 of the record. Accepting *arguendo* counsel's understanding of Judge Ryan's memorandum, I cannot assume and accept his interpretation of the colloquy at page 853 of the trial transcript. This is particularly so in light of the fact that the undersigned has been advised of the pending state action and had assumed that the parties were prepared to litigate that "non-federal" claim or claims in the state court.

[2] $750,000 of the notes, however, were convertible at the rate of $15 per share.

2, 1968, the Titan stock was at 17⅜ bid a share on the market. The notes also contained an acceleration clause which provided, among other things, that all the notes would become immediately due if any installment of interest remained unpaid for fifteen days after Titan had written notice of its default. The interest due on May 1, 1972 was not paid; Faggen, therefore, has sought to accelerate the payments due him. Titan, as indicated, has argued that to accelerate the installment payments would be to enforce a penalty.

It is generally accepted contract law that installment contracts which provide for acceleration upon default are enforcible according to their terms. See, 5 Corbin, *Contracts* Sec. 1065. Cf. *Graf* v. *Hope Bldg. Corp.*, 254 N.Y. 1, 171 N.E. 884 (1930). The interest due on the unpaid installments, however, may not be accelerated.[3] Moreover, if the parties have added the interest to be due to the principal and then divided the sum into installment payments, the acceleration clause should be unenforcible since it would result again in the payment of unearned interest. *A-Z Servicenter, Inc.* v. *Segall,* 334 Mass. 672, 138 N.Y.2d 266 (1956). See, also 5 Corbin, *Contracts* Sec. 1065.

The notes at issue bore interest at 4% annually. Faggen in his requested judgment does not seek to recover the future interest due. Titan, however, argues that the face amount of $5,500,000 fixed for the notes was established by adding interest to be paid to the principal. The stated 4% interest rate is explained away by Titan's counsel as a mere formality designed to prevent any interest from being imputed to Faggen. Adopting the finding of Frederick Shinagel, Faggen's expert, Titan now takes the position[4] that at the time of the acquisition the notes were

[3] Faggen and his counsel accept and agree to this proposition.

[4] A position which differs rather substantially from Titan's trial posture regarding Shinagel's valuation testimony.

worth only $3,200,000 and the $5,000,000 face amount factored in an additional 7% interest rate. An interest rate of 11%, plaintiff argues, is a much more reasonable interest rate than 4% for a ten year installment contract. This ingenious post-decision argument is supported by neither the documents nor other evidence of record.

The notes received by Faggen, in any case, were more than simple installment notes payable over a period of ten years. The notes also contained what was originally regarded as potentialy valuable conversion rights. Indeed, it seems probable that this conversion possibility represented an important aspect of the notes and that the stipulated interest was regarded as relatively unimportant. This supposition is buttressed by the fact that the prepayment provision of the notes required Titan to pay more than 100% of the value of the notes if it chose to prepay any part of the principal amount of the outstanding notes.

Given these facts, it cannot be said that the face amount of the notes contained or contain a concealed interest rate. Moreover, the default by Titan on the interest payments here was deliberate and not the result of a technical oversight. Titan could have chosen to pay the interest into the court for the duration of this suit but it did not do so. As a result of Titan's breach, Faggen experienced financial restraints and difficulties with lending institutions and others to his financial detriment, a fact which is at least of some relevance to a determination of whether the acceleration clause is an unenforcible penalty.

Finally, and perhaps most compellingly from an economic standpoint, it seems unrealistic to argue, as plaintiff does, that Mr. Shinagel's appraised valuation of $3,200,000 for the notes as of December 2, 1968 is appropriate value of the judgment now to be awarded Faggen on his counterclaim. Obviously, Faggen on the closing date did not receive $3,200,000, let alone the face amount of $5,500,000. Rather, he assumed the risks of the conversion to common

stock with concomitant exposure to the vicissitudes of the market—and, in the event that conversion was not feasible, of Titan's ability to continue to meet the interest payments at a comparatively modest rate and eventually pay off the principal. Given the decline of Titan's business and financial positions since late 1968, these were far from insubstantial risks, as the evidence adduced at trial plainly established. It cannot be said, however, that at the time of the sale, Faggen's business was not in fact worth $5,500,000 to Titan. Given this fact, it would not be proper for this court to say that the $5,500,000 in notes received by Faggen represented a concealed interest rate of $2,300,000. Moreover, the fact that Faggen agreed to certain unfavorable provisions in the notes is certainly no reason to refuse to enforce a provision of the notes which operated in his favor. Thus, it is difficult to view money damages in excess of $3,200,000 as constituting a penalty against Titan.

For the aforementioned reasons, it is determined that Harold Faggen is entitled to judgment on his counterclaim in the total amount of $6,378,535.68, which judgment will be entered without delay. Rule 54(b), F.R.Civ. P. The question of legal fees for defense counsel under the terms of the notes will be the subject of a further hearing and separate judgment, if the latter is appropriate.

Dated: April , 1974

HAROLD R. TYLER
U.S.D.J.

APPENDIX C

Statutes and Federal Rules Involved.

1. The Securities Exchange Act of 1934, § 10(b) (15 U.S.C. § 78j(b))

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

SEC Rule 10b-5 (17 C.F.R. § 240.10b-5)

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

APPENDIX D

Excerpt from Petitioner's Brief on Appeal, pp. 48-52, referred to at p. 14, Footnote 1 of Petition for Certiorari.

. . . Six, out of the seven directors who voted, recalled the earnings discussion at the board meeting (or thereafter) unanimously approving the transaction on October 9, 1968, as follows:

1. *Former Chairman Robinson:* "Q. Now, do you further recall . . . the earnings . . . were talked about, at the board meeting? A. . . . They were not in the minutes as I recall, and I have a recollection of the discussions of over a half million dollars earnings. Q. Pretax. A. Pretax. Q. And this was discussed by the various members . . . A. I don't know to what extent and by whom, but I remember the figure . . . it seems to me it came up ([Record on Appeal] 332). Q. Did you raise any question with respect to the earnings shown in that memo [$571,262 for 1968 in Ex. 3]? A. No . . . Q. In fact, did you not rely on those figures? A. Rely on it for what? Q. For purposes of the acquisition . . .? A. I assumed those figures were accurate" (343-344). ". . . The board's decision was to approve the recommendation of the president, which I joined;" (347-348). Robinson reaffirmed saying earlier, "I assumed the figures were accurate. Q. You relied on them, didn't you? A. I relied on them plus the examination by our treasurer" (367).

2. *Former Director Leonard Casey:* "It was presented to us on the basis that initially . . . we could acquire the company, get a yield of about ten percent on the acquisition price or somewhere in the neighborhood of 550 thousand dollars . . . Q. When you used the word 'ten percent yield on your investment,' could you explain . . . A. Well, I think they were talking about buying this company for ten times earnings . . . Q. Was any of the information in it [Ex. 3] stated to you orally at the meeting . . .? A. I believe some of it was presented by Mr. Frank at the time . . . I preferred to stay in the real estate business, but, on the recommendation of management, I voted for the acquisition" (516-517). "Q. . . . any discussion about any liquid assets which would come into possession of Titan as a result of this acquisition? A. No, I don't recall that, sir" (520). Does this indicate a desperate need for cash, erroneously assumed by the District Court?

Excerpt from Petitioner's Brief on Appeal.

3. *Former Director Alfred Frager:* "Q. What did Mr. Frank say at the board meeting . . . A. . . . He had a sheet of paper in front of him in which he quoted the results of operation . . . here was an opportunity to acquire a company, and actuarial and computer activity that billed for its service, in the area of $1,100,000, the result of which was a net profit before taxes in excess of 50% of those billings in the neighborhood of $550,000 . . . and for the figures of the preceding three years, that the figures average somewhere in the area of just a little below a half a million dollars a year . . . In addition to which the corporation had total assets in the area of $1.5 million, of which marketable securities totalled somewhere around $1 million . . . I remember the comment that any activity that could do gross billings in an area of $1.1 million and come up with such a generous pretax profit of $550,000, in that area, that I would like very much to have a piece of that. It was a splendid result" (390-391).

4. *Former Director-Treasurer McIntyre:* President Anthony Frank "asked me to check out, you know, what the adjustments were and see how they came up with the 571[000]. Q. Did you get anything in writing with respect to those adjustments? A. No. Q. How did you check them out? A. I talked to Harold about it. Q. Did you do anything else other than talk to Harold? A. Not that I remember. Q. Russo [sub-accountant] didn't do any-

thing on that subject, did he? A. Not to my knowledge. Q. Did you accept what Harold told you? A. Yes . . . Q. And did you take his word on the other items, too. A. Yes . . . Q. You took him to be an honest and truthful man, didn't you? A. Yes . . . I knew that they were talking about earnings in excess of $550,000 in the general area. Q. Right. And *you knew that is what Titan was looking for in the deal; is that right?* A. That's right . . ." (1468-1471, emph. supplied).

5. *Former Director Kurt Grunebaum:* ". . . it is quite a number of years . . . if my memory is correct, no written statement was handed out but a presentation was made by . . . Frank, and he . . . mentioned that if Titan . . . would have owned at that particular time the Faggen Corporation, the earnings would be in the neighborhood, I think, between 450 and 500 thousand dollars" (588). Cross-examination: "Q. With respect to your particular attitudes towards this acquisition at that time, was the liquid asset position of the Faggen Companies of importance to Titan at that point? A. Yes, it was of importance, *but it was one of the various factors* which . . . Q. Which entered in your judgment? A. Yes." (589, emph. supplied). Is that supposed to establish a dire cash position as the sole motive of this transaction?

6. *Former President-Director Frank:* "I said they [earnings] were above $550,000 and that they seemed to be growing at a pretty constant clip . . . And did those Board minutes [Frank participated in writing them] make any reference to any of the material you had talked about at the meeting? A. Well, as I reviewed the minutes and the exhibits here, several of the phrases in the minutes parallel the phrasing used in Exhibit 3" (284-285, 191-192A #73-1345).

7. *Former Director, Senior Vice President Eugene Hegy:* He missed the October 9, 1968 board meeting, "but

when I got back, both Dick McIntyre and Ben Robinson filled me in . . . They showed me the details, the memorandum [Ex. 3] which had been prepared, and discussed the deal generally . . . Q. Did you read the financial portion? . . . A. . . . yes, I did." (378). ". . . and I was given an opportunity to pass on the deal, as I say, like any board member. And I did, of course, approve it . . . Yes, I was given a quick rundown of the deal" (381).

8. *Former Negotiator-Lawyer Edmund Kaufman:* (not at meeting, and not a director until December, 1968 when he and Faggen both went on board): "Q. Can you identify Exhibit 3? A. Yes. That looks to me like the submission to the board of directors . . . Q. . . . Did you have familiarity in October of 1968 with the adjusted earnings figures shown on that document? A. Yes. I had quite a bit of familiarity with the adjusted earnings figure shown for the year 1968 and some rather generalized knowledge of the area of the earnings for the prior years . . . from Mr. Faggen" (143-144). ". . . And [as to the adjustments] I assumed I was dealing with a truthful man, and that he was telling me things which on their surface appeared credible" (268-269).

None of these eight individuals have worked for Titan in any capacity for years and (1) Robinson and (2) Casey were presumptively aligned with Faggen at trial (because of conflict-of-interest accusations involving them) as was (4) McIntyre who was Faggen's own witness in the summary judgment motion. The Court below recalled only (3) Frager's testimony on earnings, saying "he wasn't particularly explicit (1149), but as quoted above, he could not have been more explicit—see 390-392,[1] and the other seven

[1] The District Court had no complete transcript when it dictated findings right after summations; the trial was also disjointed, with ten partial days of hearings in February and March because of other matters pressing the Court.

were just as plain spoken. Robinson and (6) Frank also saw Faggen's 10-year projection (p. 19, *supra*) showing $570,000 in operating income as a starting base. In sum, what more evidence of earnings significant to the approval could the law require, than the recollection of virtually all the directors at the meeting and all the negotiators?

Republic Technology, Inc., supra, at p. 550 says "Where a merger is in prospect . . . the most current earnings are of the highest importance . . . Accordingly, failure to convey these earnings accurately, if the discrepancy is at all substantial, *has to be material* to the person being misled" (emph. supp.). This is another way of saying on the reliance issue that facts of fundamental materiality like overall earnings imply reliance because of their importance, also saying (at p. 551) "The materiality test is concerned only with whether a prototype reasonable investor would have relied." citing *Chris-Craft Industries* v. *Piper Aircraft, supra.* "The law will presume that plaintiff would have wanted to know the information if he had an inkling of its existence." *Stier* v. *Smith, supra.* If earnings were submitted and discussed, as they were beyond any factual doubt to eight key people, the objective significance of earnings to any acquisition imports reliance as a matter of law. The decision below cannot stand because reliance did not even have to be proven—if plaintiff is right on materiality of the omissions, *Affiliated Ute, supra,* alone requires reversal and judgment for plaintiff. But reliance was proven in any event, and also supports such reversal.

The judgment should be reversed and remanded for determination of Titan's damages from the deceptive acquisition, and payment to Faggen of fair cash value thereof, less credits and set-offs.

Supreme Court, U. S.
FILED
JUL 18 1975
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 74-1630

TITAN GROUP, INC.,

Petitioner,

against

HAROLD FAGGEN,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

	PAGE
Reasons for Denial of Certiorari	3
POINT I—This Court should not review a dismissal of petitioner's private damage claim of Rule 10b-5 fraud where the Courts below properly examined the transaction in light of the surrounding circumstances	4
POINT II—The acceleration of the debentures by virtue of the default in the payment of interest was proper	10
Conclusion	10

TABLE OF CASES

Affiliated Ute Citizens v. *United States*, 406 U.S. 128 (1972)	6, 7, 8
Arber v. *Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), cert. denied 419 U.S. 830 (1974)	7
Chris Craft Industries, Inc. v. *Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), cert. denied 414 U.S. 910 (1973)	8
City National Bank v. *Vanderboom*, 422 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970)	7
Clement A. Evans & Co. v. *McAlpine*, 434 F.2d 100 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971)	7
Competitive Associates, Inc. v. *Laventhol, Krekstein, Horwath & Horwath*, CCH Fed. Sec. L. Rep. ¶ 95,090 (2d Cir. May 8, 1975)	8, 9

PAGE

Financial Indus. Fund, Inc. v. *McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973) 7

Kohler v. *Kohler Co.*, 208 F.Supp. 808 (E.D. Wisc. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963) 7

Kohner v. *Wechsler*, CCH Fed. Sec. L. Rep. ¶ 93,537 (S.D.N.Y. June 10, 1972), aff'd as modified 477 F.2d 666 (2d Cir. 1973) 7

Landy v. *Federal Deposit Insurance Corp.*, 486 F.2d 139 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974) 7

Lewis v. *Dansker*, 357 F.Supp. 636 (S.D.N.Y. 1973) .. 8

List v. *Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965) 7

Metro-Goldwyn-Mayer v. *Ross*, 509 F.2d 930 (2d Cir. 1975) 8, 9

Ply-Gem Industries, Inc. v. *Green*, CCH Fed. Sec. L. Rep. ¶ 94,026 (S.D.N.Y. June 15, 1973), aff'd and rem., 503 F.2d 1362 (2d Cir. 1974) 7

Robinson v. *Cupples Container Co.*, 513 F.2d 1274 (9th Cir. 1975) 7, 8

Vohs v. *Dickson*, 495 F.2d 607 (5th Cir. 1974) 7

STATUTE CITED

Securities Exchange Act of 1934, Rule 10b-5 . . 2, 3, 4, 6, 8, 10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 74-1630

TITAN GROUP, INC.,

Petitioner,

against

HAROLD FAGGEN,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

This action was commenced three and one-half years after the execution of meticulously drafted contracts containing Respondent's detailed financial representations and warranties, pursuant to which contracts Petitioner acquired from Respondent four highly profitable actuarial consulting companies (the "Faggen Companies"). In its proxy statement filed with the Securities and Exchange Commission and disseminated to its shareholders six months after the closing, Petitioner acknowledged that the transaction was conducted at arm's-length and that the financial and other affairs of the Faggen Companies had been thoroughly investigated (Def. Ex. D, R. 1542).* In exchange for the

* As used herein "R" refers to the appendix before the Court of Appeals; "Pet." refers to the Petition for a Writ of Certiorari; and "Pet. A" refers to the appendices to such Petition.

Faggen Companies, Petitioner delivered to Respondent convertible subordinated debentures in the principal amount of $5,500,000 with interest at 4% per annum and with amortization of principal to occur between the sixth and tenth years.

Before having made any payment on account of principal, and after the Petitioner had withdrawn more than $2,000,000 in cash and marketable securities from the Faggen Companies, Petitioner defaulted in its interest payment and simultaneously commenced this action to rescind the transaction, alleging that there were fraudulent misrepresentations and omissions in violation of Rule 10b-5 under the Securities Exchange Act of 1934 (17 C.F.R. 240.10b-5). These alleged misrepresentations and omissions did not relate to the contract documents themselves but to a memorandum delivered two months prior thereto. The Respondent counterclaimed on the debentures which, by their terms, were accelerated by virtue of the default.

The United States District Court for the Southern District of New York, Harold R. Tyler, J., in dismissing the complaint after trial and awarding judgment to Respondent on his counterclaim, held that Respondent had made no misrepresentation and did not omit to state any material fact. The Court of Appeals for the Second Circuit (Waterman, Oakes and Gurfein, JJ.) unanimously affirmed. Rehearing and rehearing en banc were denied. Petitioner now seeks review of these determinations claiming that the factual findings were erroneous because the courts failed to apply the proper standards of reliance and materiality to the aforesaid memorandum. The facts relating to this case are fully detailed in the opinions below.

Notwithstanding the Trial Court's express factual findings to the contrary and the affirmance by the Court of Appeals of those findings, Petitioner in disregard of those findings continues to assert that Respondent omitted to disclose a loss of clients, by virtue of which Petitioner purchased a "shrinking business" (Pet. 4, 5),* and that Respondent omitted to disclose the assumptions upon which the adjusted earnings were based (Pet. 5, 7). As to both contentions which relate only to issues of fact and not to questions of law, the Courts below found for Respondent (Pet. A 5a-7a, 15a, 19a, 20a, 31a-34a).

Reasons for Denial of Certiorari

1—This Court should not review factual findings, affirmed by the Court of Appeals, that Respondent made no false statement and did not omit to state any material fact necessary to make the statements made not misleading.

2—This Court should not accede to Petitioner's request to rewrite Rule 10b-5(2) so as to bar the presently required

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* Petitioner does more than disregard the findings. It actually distorts the record. Thus, it states: "Undisputed evidence showed a $386,922 shrinkage (40%) of the $1 million gross actuarial business of the Faggen Companies between 1966 and 1973" (Pet. 6). The undisputed evidence is directly to the contrary. The President of Petitioner's actuarial division testified that in 1969 the company acquired a single client whose volume exceeded $250,000 and that the gross actuarial business of the Faggen Companies did *not* shrink (R. 811, 819-20). This testimony was summarized in one question and answer:

> The Court: And if I also understand your testimony, though it is true in this period of time, those years, you lost about forty clients, it did not have any great impact upon the gross or the volume, to use your word, partly because you picked up one new client which practically absorbed or virtually came close to absorbing the loss of billings or volume which went out with the forty?
>
> The Witness: Yes.

(R. 819-20)

Petitioner's so-called "undisputed evidence" consists of a list of clients lost in the eight years from 1966 to 1973, inclusive, three years before and five years after acquisition, but fails to include any new clients gained in the same period. Yet the person who on Petitioner's behalf prepared that list, testified that "like any other business, there were clients gained [and] clients lost" by the Faggen Companies during those years (R. 793).

inquiry into the particular circumstances of a transaction in determining the materiality of the alleged omissions, for to do so would reverse an unbroken line of cases requiring a plaintiff to establish causation in fact as a necessary element in a Rule 10b-5 claim.

3—This Court should not review a judgment for the principal amount of debentures properly accelerated by Petitioner's default.

POINT I

This Court should not review a dismissal of petitioner's private damage claim of Rule 10b-5 fraud where the Courts below properly examined the transaction in light of the surrounding circumstances.

The Trial Court found, and the Court of Appeals affirmed, that Petitioner failed to prove, as Rule 10b-5(2) requires, that Respondent had made a misleading statement or omitted "to state a material fact, necessary in order to make the statements made, *in the light of the circumstances under which they were made,* not misleading."

As to each of Petitioner's factual contentions in its Petition, the trial Court found and the Court of Appeals affirmed that there had been no shrinking business, that the memorandum of adjusted earnings was reasonable and that Petitioner was aware of the assumptions underlying the adjustments (Pet. A 4a-6a).

Notwithstanding these express factual findings against it, and the plain language of Rule 10b-5, Petitioner argues that Judge Tyler should have ignored the circumstances of the transaction* and instead should have found, and the

* Petitioner contends that the Court may not consider the "circumstances" of the transaction in determining the materiality of an

(*footnote continued on following page*)

Court of Appeals should have affirmed, that there was a shrinking business, that the adjusted earnings were not reasonable and that the basis for the adjustments was not disclosed—that somehow the courts below would have made such findings if, instead of judging the Petitioner in the light of the circumstances surrounding this transaction, they had substituted for the Petitioner a hypothetical "reasonable investor".

In egregious unconcern for the record, but as a make weight for its argument that a different factual finding would have resulted if the hypothetical "reasonable investor" had been substituted for Petitioner, Petitioner now, for the first time, accuses Judge Tyler of making his findings on the basis of his "prejudicial opinions of small conglomerates, circa 1968, and their particular negotiating agents" (Pet. 18). Petitioner makes not a single record reference in support of this startling accusation. It never made any such accusation before the Court of Appeals and in making such accusation before this Court it implies that the Court of Appeals was likewise so moved since that Court found that there was abundant record evidence to support Judge Tyler's findings.

Notwithstanding the indefensible charge against the courts below, the substitution of the "reasonable investor" for the Petitioner would not have changed the facts that there was no shrinking business, the adjusted earnings were reasonable and Respondent disclosed the assumptions upon which the adjusted earnings were based.

Finally, it is frivolous for Petitioner to suggest that the substitution of a "reasonable investor" for the actual

(*footnote continued from preceding page*)

omission; that the Court of Appeals supplanted "objective materiality" with "circumstances" (Pet. 18) that it was improper for the trial court to attempt to reconstruct the "circumstances" of the omission (Pet. 19); and that the Court of Appeals substituted the "uncertain doctrine of 'circumstances' " for an "objective rule of law". (Pet. 5)

investor would eliminate the potential for a trial Court's prejudice. Disregarding for the moment the plain language of Rule 10b-5, the substitution by the Court of its own "reasonable investor" judgment in all cases, regardless of the circumstances, would open wide the doors to the very potential which Petitioner ostensibly seeks to avoid. Rule 10b-5 requires a factual determination in light of the circumstances surrounding the transaction and that means making a determination based upon the parties to the transaction as well as the transaction itself. *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972), did not rewrite Rule 10b-5 to eliminate the requirement of an examination into such circumstances, it simply permitted resort to a fictional "reasonable investor" where proof of reliance with respect to a particular investor was difficult. To suggest that what *Affiliated Ute* intended was to substitute the "reasonable investor" in all cases regardless of the circumstances is to suggest that the "circumstances" language of Rule 10b-5 is meaningless.

Implicit in Petitioner's contention that the Court below erred in considering the materiality of the alleged omissions applicable to the Petitioner, rather than to some hypothetical "reasonable investor", is the suggestion that, in determining who that "reasonable investor" was, the Courts should have ignored the sophistication or knowledge of the parties.

The materiality requirement of a Rule 10b-5 fraud case requires the court to examine the circumstances and to reject the notion that the transaction, or the parties, be examined in a vacuum. Consequently, where the parties are sophisticated, have business experience and expertise, are acquainted with the affairs of the corporation whose securities they purchase, and have access to the information alleged to be misrepresented, the Courts have consistently inquired into the materiality to the particular investor of the alleged misrepresentations and omissions,

and have generally denied relief in the absence of strong affirmative proof by the plaintiff that the particular misstatement or omission complained of was material to such plaintiff. Such cases include: *List* v. *Fashion Park, Inc.,* 340 F.2d 457 (2d Cir.) cert. denied, 382 U.S. 811 (1965); *Kohner* v. *Wechsler,* CCH Fed. Sec. L. Rep. ¶ 93,537 (S.D.N.Y. June 10, 1972), aff'd as modified, 477 F.2d 666 (2d Cir. 1973); *Ply-Gem Indus., Inc.* v. *Green,* CCH Fed. Sec. L. Rep. ¶ 94,026 (S.D.N.Y. June 15, 1973), aff'd and rem., 503 F.2d 1362 (2d Cir. 1974); *Kohler* v. *Kohler Co.,* 208 F.Supp. 808 (E.D. Wisc. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963); *City National Bank* v. *Vanderboom,* 422 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970); *Clement A. Evans & Co.* v. *McAlpine,* 434 F.2d 100 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971); *Robinson* v. *Cupples Container Co.,* 513 F.2d 1274 (9th Cir. 1975); *Financial Indus. Fund, Inc.* v. *McDonnell Douglas Corp.,* 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973); *Landy* v. *Federal Deposit Insurance Corp.,* 486 F.2d 139 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); and *Arber* v. *Essex Wire Corp.,* 490 F.2d 414 (6th Cir.), cert. denied, 419 U.S. 830 (1974); *Vohs* v. *Dickson,* 495 F.2d 607 (5th Cir. 1974).

What is material to an unsophisticated investor (as in *Affiliated Ute*) may not be to a conglomerate corporation. See *Arber* v. *Essex Wire Corporation, supra,* and *Robinson* v. *Cupples Container Co., supra.* In contradiction of the authorities cited in the paragraph above, Petitioner argues that materiality cannot vary with the circumstances of the particular transaction or the parties thereto—that a statement or omission from a document is or is not material, regardless of the sophistication of the parties or the events which preceded the delivery of the document in question or the conversations that related thereto or the investigation that followed the document or the contractual

representations that ultimately were made. Materiality, Petitioner claims, is a matter of law (Pet. 5).

While materiality may be a rule of law, what is material is a question of fact (see, e.g., *Robinson* v. *Cupples, Container Co., supra; Lewis* v. *Dansker,* 357 F.Supp. 636, 642 (S.D.N.Y. 1973). Omissions are never material as a matter of law until their materiality has been factually determined.

As the Court below observed (Pet. A 7a-8a), causation in fact is a fundamental element in a Rule 10b-5 private action. Causation is established by materiality and, in appropriate cases, reliance.

Contrary to Petitioner's contention (Pet. 10), there is nothing novel in Judge Waterman's statement (Pet. A 7a) that *Affiliated Ute* did not abolish reliance as a prerequisite to recovery and that only where proof of reliance was difficult as a practical matter did *Affiliated Ute* authorize proof of materiality in lieu thereof. See *Chris Craft Industries, Inc.* v. *Piper Aircraft Corp.,* 480 F.2d 341, 374 (2d Cir. 1973), cert. denied, 414 U.S. 910 (1973).

The Court of Appeals rejected Petitioner's contention that *Affiliated Ute* eliminated reliance as an element in all Rule 10b-5 actions involving omissions of material fact (Pet. A 7a). Having lost that argument, Petitioner now asserts, contrary to Rule 10b-5 and the aforementioned authorities, that, because it should have been judged as a "reasonable investor", instead of what it was, it was not even required to prove materiality in the circumstances of its case (Pet. 5, 18, 20, 21).

Petitioner asserts that Judge Waterman's opinion is inconsistent with two recent opinions in the Second Circuit—*Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath,* CCH Fed. Sec. L. Rep. ¶ 95,090 (2d Cir. May 8, 1975) and *Metro-Goldwyn-Mayer* v. *Ross,* 509 F.2d 930 (2d Cir. 1975). These opinions were brought to

the attention of the panel which decided this case, both before the opinion was rendered and thereafter in the petition for rehearing or rehearing *en banc.*

The *Competitive Associates* and *Metro-Goldwyn-Mayer* opinions are clearly consistent with, and indeed support, the Court's decision in this case. *Competitive Associates* reversed a decision granting summary judgment because the District Court "was premature in denying [plaintiff] an opportunity to prove its claims" (CCH p. 97,866) and remanded the case for trial, holding that the plaintiff was required to prove causation in fact and to "allege that it would not have acted as it did had it known of the information withheld by defendants" (CCH p. 97,865). The Court did not hold that plaintiff would recover even if it failed to prove the allegation—if it could not establish causation in fact. Yet, that is what Petitioner seeks here, for in this case Petitioner failed to prove the allegations in its complaint.

Contrary to Petitioner's assertion, *Metro-Goldwyn-Mayer* v. *Ross, supra,* was not a legally identical situation to the case at bar; there the District Court found an omitted fact to be material (509 F.2d at 933), but nevertheless rejected plaintiff's claim for rescission. In the instant case, the District Court found no material omission. In *Metro-Goldwyn-Mayer,* the Court of Appeals reversed on the strength of the materiality of the omission combined with a breach of a contractual representation in the exchange agreement. Here, the Court of Appeals affirmed—because there was neither a material omission nor breach of any contractual representation.

Finally, Petitioner's argument that the Court of Appeals excluded "all disclosure accounting principles from this case" (Pet. 19) is a distortion of the Court's opinion. The Court held that the summary of adjusted earnings was neither false nor misleading. The Court found that the summary was not a financial report to which ac-

counting principles and rules apply, but an accurate portrayal of exactly what it purported to be—"an approximation of what the Faggen Companies would earn through the elimination of certain expenses if the companies were publicly, rather than privately, owned" (Pet. A 6a). Nowhere does Petitioner mention, as the courts below observed, that there was neither a claim nor proof that there was any false or misleading statement in the historical financials incorporated into the definitive contracts which were represented by Respondent to be accurate and that on the trial each of the Petitioner's financial experts, as well as the lawyer who negotiated the deal on Petitioner's behalf, conceded that these financials were accurate in all respects (R. 254, 564, 654, 705).

POINT II

The acceleration of the debentures by virtue of the default in the payment of interest was proper.

In rejecting Petitioner's claim, Judge Tyler in a separate opinion (Pet. A 36a, et seq.) affirmed by the Court of Appeals (Pet. A 9a-10a) found that there was neither hidden interest nor a penalty in the debentures and that the debentures were therefore enforcable in accordance with their terms. There is no compelling reason to review that essentially factual determination.

Conclusion

The District Court found and the Court of Appeals affirmed that the Respondent was not guilty of any fraudulent misrepresentation or omission in connection with the transaction. The Petitioner would rewrite Rule 10b-5 and would reverse a host of authorities which require that a transaction be judged in light of all surrounding circum-

stances. Petitioner would eliminate causation in fact as a prerequisite to recovery. The courts below properly applied the requirements of Rule 10b-5 in making their factual determinations. There is no conflict among the Circuits on the issues raised. There is no reason for this Court to grant this Petition. The writ should be denied.

Respectfully Submitted,

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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 74—1630

TITAN GROUP, INC.,

Petitioner,

against

HAROLD FAGGEN,

Respondent.

REPLY PETITION TO CORRECT STATEMENTS BY RESPONDENTS AND OTHER MATTERS

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Northway, Inc. v. *TSC Industries, Inc.*, CCH Sec. L. Rep. ¶ 95,007 (—— F.2d ——, March 5, 1975) .. 9

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Loss on Securities Regulations 10

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REPLY PETITION TO CORRECT STATEMENTS BY RESPONDENTS AND OTHER MATTERS

We find the unusual necessity of filing a Reply Petition for the following reasons. On page 3 of Respondent's Brief In Opposition, a serious and incorrect assertion is made that Petitioner "distorts the record" as to the "$386,922 (40%) shrinkage of the $1 million gross actuarial business of the Faggen Companies between 1966 and 1973." As will be shown, it is Respondent who distorts the record on this undisputed factual matter:

1. *Loss of Clients.* The Faggen Companies were acquired from Respondent Harold Faggen on December 2, 1968. Any new business they acquired in 1969, which offset *undisclosed* losses of clients in 1968, did not correct

omissions to disclose before Titan made the acquisition. Titan bought a presumably growing business, at ten times future earnings, not one that was, at best, standing still, and scurrying, after the acquisition was closed, to make up for undisclosed lost clients with new clients. And even with later new clients, the net trend was materially downward from 1968 through 1973, with the adverse trend undisclosed as of December 2, 1968.

The facts on this point are plain in the record. Faggen said in his own handwriting in his 1968 selling memo to Titan:

"Analysis of Clients

	Pension Funds	*Welfare Funds*	*Other*	*Total*
New in 1968	2		2	4
New in 1967	3	1	3	7
New in 1966	5	1	1	7
New in 1965		1	1	2
New in 1960-1964	19	14	2	35
Began prior to 1960	49	36	3	88
Total	78	53	12	143"

(Trial App. 1366, 1372)

Compare this "bullish" presentation of a growing business, adding several new clients yearly through 1968 for a total of 143, with the schedule of lost clients undisclosed, in the record:

Schedule of Lost Clients

TITAN ACTUARIAL SERVICES, INC.
1964-1973

Fiscal Year Ended June 30, 1966		
Local 26 Pension Fund		$ 2,000
Fiscal Year Ended June 30, 1967		
I.U.O.E. Welfare Fund Local 137A, 137B	$ 2,400	
Supplemental Unemployment Benefit Fund Local 137	2,400	
		$ 4,800
Fiscal Year Ended June 30, 1968		
Bartenders Union Loc. 29 Pension	2,500	
Bartenders Union Loc. 29 Welfare	2,000	
NYC District Council of Carpenters Union	50,000	
NYC District Council of Carpenters Welfare	28,000	
Local 164 Insurance Fund	3,600	
Local 164 Pension Fund	2,100	
Metro I.L.A. Pension Fund	4,500	
Upstate Printers Pension	2,000	
Local 806 Teamsters Pension	2,000	
		$96,700
. . . [1969-1973]		.....

(Trial App. 1396-1398)

The undisclosed 10% loss of clientele before the acquisition closed is there in the 1966-1968 entries, bound to adversely affect profits thereafter by some 20% (since

overhead remained the same). There was no disclosure of the loss of the single biggest client group—NYC District Council of Carpenters ($78,000 annually), nor of the beginning of loss of the whole Bartenders' Union Group in 1968, culminating in 1969 (see balance of this exhibit, 1969-73, Trial App. 1396-1398). The factual assertions on page 6 of our Petition, detailing omissions to disclose material decline in clients are indisputable.

In a desperate attempt to avoid these facts, Respondent quotes the Record on a single question by the Court as to a large new client obtained in 1969, *after* the acquisition (and therefore irrelevant to non-disclosures before acquisition). The question dealt with the continuing decline in actuarial consulting business after acquisition, while a doomed attempt at going into the computer business became an increasing source of volume to the Faggen Companies (all handled at a substantial loss). We quote the transcript page cited by Respondent:

> "A. So I would say what was happening was the data processing was taking over a larger and larger portion of the total volume of business. Percentage wise, it got to the point where it was probably thirty, forty percent of the total volume of the company.
>
> Q. [the Court] What was happening to the actuarial business during this period in terms of volume?
>
> • • •
>
> A. Well, in '69 we lost over $100 thousand just in clients, just to Levin Townsend, so there was some shrinkage there. Let me put it this way. A unique thing happened, we lost maybe forty clients whose total billing may have amounted to $300 thousand or maybe under $300 thousand, maybe 250, and they were replaced instantly by one client whose volume exceeded that. . . . the actuarial volume, it probably stayed about the same." (Trial App. 811-812)

Confirming that this testimony related only to what happened *after* the acquisition, events that in fact masked the undisclosed decline in clientele before the 1968 closing, we quote the page cited by Respondent:

> "The Court: All right. Now am I also right in understanding that as time went along *up through 1969 up through 1972,* let us say, that the actuarial business gradually came to represent a lesser percentile of the total gross volume than it had when you first arrived say in '68?
>
> The Witness: Right.
>
> The Court: . . . you picked up one new client which practically absorbed or virtually came close to absorbing the loss of billings or volume which went out with the forty?
>
> The Witness: Yes." (Trial App. 819-820)

More significantly, the forty lost clients referred to are those lost to Levin Townsend early in 1969 (a list of 34, actually, Trial App. 1397). Before the acquisition, there was an undisclosed loss of 12 other clients, with aggregate gross billings of $103,500. These in themselves were the key material omission—10% of volume, and 20% decline in profits. The Levin Townsend loss of clients was simply another $109,682 in annual billings lost in 1969 after the acquisition closed.

It is these hard facts which make up the substance of an objective test for materiality of a non-disclosure. What happened later to cover up an undisclosed decline in gross business is irrelevant to whether a reasonable investor might have wanted to know the conceded decline as of December, 1968. The District Court ignored an objective standard for evaluating an omission when it occurred, and used subsequent events as a basis to call the omission inconsequential. Its erroneous reasoning demonstrates the need for review under the test set forth in *Affiliated Ute Citizens* v. *U. S.,* 406 U.S. 89 (1972).

2. *Receipts and Disbursements by each Litigant.* Respondent argues on page 2 of its brief: "Before having made any payment on account of principal and after the Petitioner had withdrawn more than $2,000,000 in cash . . . from the Faggen Companies, Petitioner defaulted in its interest payment and . . . commenced this action to rescind the transaction." The Respondent erroneously suggests that there is something wrong in a parent of a wholly-owned subsidiary taking excess net worth in the subsidiary, held in cash and marketable securities, and liquidating them for use in other divisions of the parent corporation's business. The Respondent also fails to state that Titan Group, Inc. caused to be paid to Respondent, Harold Faggen, $660,000 in interest plus substantial salary payments and expense allowances to Mr. Faggen and his wife, aggregating a total of over $1 million between the acquisition date of the Faggen companies and the filing of this action claiming fraud. Moreover, Titan at all times claimed that the value of the Faggen companies was approximately $1.6 million to $2 million in its recent action, subject to setoffs and adjustments to each party to the contract. Respondent attempts to obtain some perjorative effect from the normal handling of the cash and other assets of a wholly-owned subsidiary by a parent corporation after purchase, during the fiscal years before investigation led to the conclusion that the parent corporation had been defrauded, and must take court action to establish each party's respective claim.

3. *The Objective Test of Affiliated Ute Is Being Uniformly Applied by the Circuits, Except for the Anomaly in the Instant Case.* Respondent attempts to argue that the language of Rule 10b-5(2), taken from Section 17(a) of the Securities Act of 1933 and incorporated in a parallel anti-fraud rule of the Securities Exchange Act of 1934, creates a statutory test for deception which is other than the "reasonable man" test of general tort law and *Affiliated Ute Citizens* v. *U. S., supra.* Respondent urges that the language omitted "to state a material fact, necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" means that a circumstantial test must be applied by a trier of fact to determine *materiality* in an omissions case. Nothing could be further from the Congressional intent or the clear stream of authority under Rule 10b-5. As Bromberg, SECURITIES LAW, Sec. 2.6(2), points out under Rule 10b-5(2): "Clause 2, by its own terms, operates only if some statement is made and this outlaws half truths and other forms of partial silence or failure to disclose." In other words, the statutory test for the deceptiveness of an omission is whether, "in the light of the circumstances" under which other statements were made, material facts should have been disclosed, because they were "necessary in order to make the statements made" not misleading. In substance, an omission to state a material fact necessary to make other statements not misleading, always requires other statements to have been made. This principle of interpretation in *Bromberg* is cited with approval in *Affiliated Ute Citizens* v. *U. S.*, 406 U.S. at 154. In the instant case, the other statements that were made consisted of a list of new clients noted above, and a statement of adjusted net income quoted in our Petition. It was the omissions from these statements which were necessary in order to make these statements, in the light of the circumstances under which they were made, i.e. factual inducements to a transaction in securities, not misleading. Respondent's argument, based on the statutory language, is wide of the mark on the issue in the instant case.

The issue here is the *materiality* of the particular omissions under analysis. And on the materiality question the *Affiliated Ute* test is the objective one, whether a reasonable investor might have considered the omissions important. Respondent's brief is an attempt to take the language "in the light of the circumstances under which they were made" out of its statutory context, applicable to the *statements made,* and transfer that concept of a cir-

cumstantial test into an analysis of *materiality* of omissions. With all respect, it is mixing apples with oranges.

The authorities cited in a lengthy string of citations in support of Respondent's erroneous theory do not withstand analysis. Taking two of the most recent authorities in the Sixth and Ninth Circuits, we note the following:

In *Arber* v. *Essex Wire Corporation,* 490 F. 2d 414 (6th Cir., 1974), the plaintiff was unable to meet his burden of proof under Rule 10b-5 and lost the case. But the analytical test used by the Court was based on *Affiliated Ute Citizens, supra,* and was exactly the objective test which we urge should have been used by the Second Circuit and by the District Court in the instant case. At 490 F. 2d 418, the Sixth Circuit articulates the "reasonable man" test in an omissions case, and states that it is taking the omissions "to assess the significance, from a reasonable person's viewpoint in the context of the 1961 sale, of any nondisclosures." In stating its conclusion (490 F. 2d 419-420), the Court said:

> ". . . In this context, we do not think that detailed knowledge of the precise mechanism for establishing the 'going price' would have affected the choice of action of a reasonable person in the position of the Arbers."

The Sixth Circuit further stated (490 F. 2d, 421, ftn. 7) in referring to the *Ute* test:

> "This, of course, makes clear that the Record in a 10b-5 action for nondisclosure need not contain an affirmative demonstration of plaintiffs' reliance."

Another recent citation by respondent, *Robinson* v. *Cupples Container Co.,* 513 F. 2d 1274 (9th Cir. 1975), wherein the plaintiff also did not make his case, further demonstrates the uniform application in the Circuits of the *Ute* test. The Ninth Circuit (513 F. 2d, at 1277) applied a

principle it had stated in *Marx* v. *Computer Sciences Corporation,* 507 F. 2d 485, 489 (9th Cir. 1974):

> "The applicable test of materiality is essentially objective . . . in determining his choice of action in the transaction in question.' . . ."

Indicating the analytical test used by the Ninth Circuit, the Court stated in the dispositive portion of its opinion, "The alleged promise of employment cannot be regarded as a matter to which a reasonable investor would attach importance where it was made at an exploratory meeting . . ." (513 F.2d at 1278). In the *Robinson* case the plaintiff was claiming that it was represented to him that defendant intended to place him in charge of all cup manufacturing operations after the merger, and defendant had no such intention; the Court thus held a reasonable man would not have attached importance to such vague statement of intent.

For another recent statement of the applicable "might have considered important" test, see the Seventh Circuit in *Northway, Inc.* v. *TSC Industries, Inc.,* CCH Sec. L. Rep. ¶ 95,007 at p. 97,487 (—— F. 2d ——, March 5, 1975).

In the instant case, the same reasonable man test should have been applied to the written representations of (a) new clients and (b) substantial earning power, where there were omissions of substance relating to each of these written statements. Obviously, a court must inquire into the nature of the securities transaction to decide what might be important to the reasonable investor in that type of transaction. In an acquisition transaction, it is hard to conceive of anything being more material than (a) the gross volume of business of the acquiree, and whether or not such volume is declining, and (b) the earning power of the acquiree, together with the conceptual framework used to demonstrate such power, i.e., the basis for the "adjustments." "The value of an acquired firm is determined, in part, by the stream of earnings which it is expected to

contribute to the acquiring firm." *Champion Home Builders Co.* v. *Jeffress,* CCH Sec. L. Rep. ¶ 94,973 at p. 97,364 (1974, E.D. Mich.).

4. *The Contract Documents Are of Little Signifiance Herein.* At bottom, respondent's position is one which was rejected even by the District Court. It is an argument that, if the formal contracts did not contain references to the items of fact as to which there were claimed material omissions, a plaintiff cannot base a Rule 10b-5 case on such omissions. The peroration of Respondent's brief (p. 10) stresses this position, that if the financial statements on a cash basis of a privately held business as incorporated in their tax returns were annexed to the contract, and proved to be accurate as prepared, then plaintiff cannot look beyond the contract documents to show material omissions and other factual statements presented to induce the transaction. Such principle was rejected many decades ago in decisions like *Arnold* v. *National Aniline & Chemical Co.,* 20 F. 2d 364, 369 (2d Cir. 1927)—"No form of contract can stand if induced by fraud." No contract can grant immunity from fraud in its inducement, *Sabo* v. *Delman,* 3 N.Y. 2d 155 (1957). Fraud, including fraud based upon material omissions to disclose, vitiates any contract despite provisions that all understandings are merged therein, that an investigation has been made, that there was no reliance on any representation by an exhibit not in the agreement, or that complaint must be made within a specified time period. *Rizzi* v. *Sussman,* 195 N. Y. S. 2d 672 (A.D. 2d, 1959); *Massler* v. *Smit,* 111 N.Y.S. 2d 264 (A.D. 2d, 1952). Section 29(b) of the Securities Exchange Act of 1934 expands upon this common law principle—"The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences." *Kardon* v. *National Gypsum Co.,* 69 F. Supp. 512, 514 (E.D., Pa. 1946). Bromberg, *supra,* pp. 31-32, and Loss on SECURITIES REGULATIONS, p. 1757, ground the whole field of civil liability under Rule

10b-5 on this principle, that the presence or absence of an exhibit or of a representation, or any other acquisition contract "boilerplate" cannot foreclose a fraud inquiry which searches the record. See *Rogen* v. *Ilikon Corporation,* 361 F. 2d 260 (1st Cir. 1966), and *Bankers Life & Casualty Co.* v. *Bellanca Corp.,* 288 F. 2d 784 (7th Cir. 1961). Respondent's argument was even rejected by the District Court, which said: "The case law supports [you]" for fraud in inducing the contract opens the door to the essential business sales talk used to induce the transaction (Trial App. 1097). Thus, Respondent Faggen could not escape the impact of his detailed list of new clients, omitting material adverse facts, or of his pro forma earnings presentation, omitting questionable adjustments and assumptions, which were the sales tool used to effect a transaction, merely because cash basis tax returns instead of complete financial statements were made part of the contracts. Even the contractual boilerplate, although irrelevant, picks up the selling material which was the key to this case. Section 3.23 of the relevant contract says:

> "*Material Misstatements or Omissions.* No . . . document, statement, certificate or schedule furnished to Titan . . . in connection with the transactions contemplated hereby, contains . . . any untrue statement of a material fact necessary to make the statements or facts contained therein not misleading." (Trial App. 1638-1639)

The list of new clients and a pro forma summary of adjusted income for each corporation for four years are certainly "documents," "statements" or "schedules" furnished to Titan "in connection with" its acquisition transaction. But this was not a suit on a contract, but rather, under the federal securities laws, for fraud in its inducement. The contract provisions, and the accuracy of the financials or other exhibits to the contract, cannot foreclose intensive analysis of the selling memorandum used to induce the

contract. And that analysis, we respectfully submit, must be pursuant to the objective test for materiality of *Affiliated Ute,* in order to measure the significance of the omissions from this selling memorandum.

CONCLUSION

We respectfully pray that the petition for certiorari be granted to review this important principle of federal securities law in the instant case.

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Respectfully submitted,

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